

VOL. XXXI NO. 3  
THIRD QUARTER  
2003

# The Indonesian Quarterly

## CURRENT EVENTS

- Indonesia and the IMF: Exiting Assistance,  
Entering Post-Program Monitoring
- The Aceh Conflict: The Long Road to Peace
- Overview of the Political Dimension of ASEAN's Security

## VIEW OF POLITICAL DEVELOPMENT

- National Stability at Stake?

## VIEW OF ECONOMIC DEVELOPMENT

- Improved Macroeconomic Condition

## ARTICLES

- ASEAN Economic Community:  
Ideas, Significance and Feasibility
- The Impact of ASEAN-China FTA on ASEAN Economies
- Indonesia's Experiences in Facilitating Peace Process
- Greater Relevance of An Industrial Economics Approach  
in Emerging Rather than Developed Markets



CENTRE FOR STRATEGIC  
AND  
INTERNATIONAL  
STUDIES

## The Quarterly

*The Indonesian Quarterly* is a journal of policy oriented studies published by the Centre for Strategic and International Studies (CSIS), Jalan Tanah Abang III/23-27, Jakarta 10160. It is a medium for research findings, evaluations and views of scholars, statesmen and thinkers on the Indonesian situation and its problems. It is also a medium for Indonesian views on regional and global problems. The opinions expressed in *The Indonesian Quarterly* are those of their authors and do not necessarily reflect the opinion of the CSIS.

## The Logo



To better represent the underlying ideas that gave birth to the CSIS in 1971 the Centre uses as of 1989 the logo that figures on the front cover of this journal. The original, in bronze, designed by G. Sidharta, it consists of a disc with an engraving that depicts the globe which serves as a background to a naked man with an open book laid on a cloth over his lap, his left hand pointing into the book, his right hand raised upwards. Altogether it symbolises the Centre's nature as an institution where people think, learn and communicate their knowledge to whoever are interested, to share it with them, mankind the world over being their concern and the globe their horizon. The nakedness symbolises the open-mindedness, the absence of prejudice, in the attitude of the scholars who work with the Centre, just as it is with scholars everywhere. The inscription reads "*Nalar Ajar Terus Budi*", which in the Javanese language essentially means that to think and to share knowledge are only the natural consequence of an enlightened mind. It is a *surya sengkala*, that is *chandra sengkala*, a Javanese traditional way to symbolise a memorable year in the lunar calendar, adapted to the solar calendar system. It consists in using words that express the perceived meaning of the commemorated year while marking the year at the same time, each word having a numerical value. Thus, the inscription, in reverse order, represents the year the CSIS was established: 1971.

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SIT

01381/SK/Dirjen PG/SIT/72

ISSN

0304-2170

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# ABSTRACTS

## ASEAN ECONOMIC COMMUNITY: IDEAS, SIGNIFICANCE AND FEASIBILITY

*By Hadi Soesastro*

This idea on the formation of an ASEAN Economic Community (AEC) by 2020 has been included in ASEAN's agenda since it was proposed by PM Goh Cok Tong at the ASEAN Summit in 2002. The creation of an AEC is a feasible proposition. The AEC should be seen as a logical extension of the various initiatives taken and implemented by ASEAN thus far towards greater economic integration. The question is whether there is political will on the part of ASEAN leaders to commit themselves towards the creation of an AEC by 2020.

## THE IMPACT OF ASEAN-CHINA FTA ON ASEAN ECONOMIES

*By Mohamed Aslam*

This article discusses the ASEAN-China FTA and its impact on ASEAN economies. At the ASEAN Summit in Manila 1999, members of ASEAN, China, Japan and South Korea had reached a joint statement to form a free trade area by the year 2020. In November 2002 at the ministerial meeting, ASEAN and China signed an agreement to form a Free Trade Area (FTA) by the year 2010. The ASEAN-China FTA is the first phase of the East Asian FTA. The establishment of a Free Trade Area (FTA) between ASEAN and China will create an economic region of 1.7 billion consumers, regional GDP of about US\$2 trillion and total trade is estimated at US\$1.23 trillion. The author argues that the ASEAN-China FTA could become a large free trade arrangement in the world. However, if some members of the pact experience losses, it will accordingly dent the pact.

## INDONESIA'S EXPERIENCES IN FACILITATING PEACE PROCESS

*By Teuku Faizasyah*

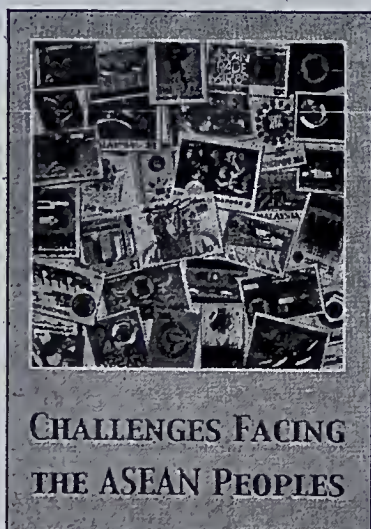
The role of third party in the peace process is indeed essential if the dispute is to be resolved amicably. This article explores the role and experiences of Indonesia in facilitating a peace process. It is a fact that Indonesia has been quite successful in mediating a conflicts in Cambodian and Moro. Factors responsible for Indonesia's success in paving

the way for conflict settlement include the eagerness of the Indonesian Foreign Ministry's bureaucracy to achieve tangible results from diplomacy and the efficacy of their overall approaches: the combination of informal and formal diplomatic approaches.

## GREATER RELEVANCE OF AN INDUSTRIAL ECONOMICS APPROACH IN EMERGING RATHER THAN DEVELOPED MARKETS

By Heike Proff

This article analysis the relevance of an industrial economics approach in emerging markets. The relative significance of industrial economic approaches in developed markets is generally lower in comparison to the resource-based or competence-based approaches. The author not only attempts to show that the opposite is exactly true for emerging markets where industrialization is used as a means to achieve economic development, but also explained the significance of industrialization as a component of the development process which implies that an industrial economies approach possesses greater relevance for tapping emerging markets.



## CHALLENGES FACING THE ASEAN PEOPLES

*Published by:* Centre for Strategic and International Studies (CSIS), Jakarta.

This book is a the proceedings of the second ASEAN People's Assembly (APA) held in Bali from 30 August to 1 September 2002. With the theme 'We the ASEAN People and Our Challenges', APA 2002 was meant to be an effort made by civil society in Southeast Asia to change the paradigm of governance and societal development in Southeast Asia — from one that is state security oriented to the one that is more human security oriented.

Apart from the summary of and major suggestions made at the meeting, the background papers prepared by a number of speakers are also included in this publication.

This book is recommended for those who are interested in examining the broad range of challenges faced by the ASEAN peoples and the ideas about people-oriented programs and action plans to respond to those challenges.

*Contributors:* Hadi Soesastro, Carolina P. Araullo, Roy Chan, Ramon M. Flores, Kek Galabru, Mirna Galic, James Gomez, Rustam Ibrahim, Souphanh Keokhamphet, Kwok Kian Woon, Todung Mulya Lubis, A. Mendoza, Jr., Lily Zakiah Munir, Alberto T. Muyot, Tisa Ng, Doan Ngu, Surachai Nira, Sakkarin Niyomsilpa, Don Pathan, Prapart Pintobtang, Dang Thi Quyet, Melita L. Salvador, Tan Sri Dr Noordin Sopiee, Bounphone Soulinthone, M.R. Sukhumbhand Paribatra.

2003. 1st Ed., viii + 360 pp.; 25 cm, ISBN 979-8026-82-9; Rp 70.000,00  
Rp 70.000,00 + postage charge 15% for Indonesia  
US\$29.00 + postage charge by airmail for overseas



# Indonesia and the IMF Exiting Assistance, Entering Post-Program Monitoring

*Ari A. Perdana*

**T**HE government of Indonesia finally decided not to renew the International Monetary Fund (IMF) economic assistance program when it expires at the end of the year. The decision, taken by the government at the end of July, ended with the lengthy debate on the continuing presence of the Fund in Indonesia. The IMF will continue monitoring the country's economic reform program under the Post-Program Monitoring (PPM) arrangement starting next year.

Under the PPM, the government will be able to spread the repayments of US\$9.2 billion in the debts it owes to the Fund until 2010. Alternatively, the government may avoid PPM but will have to repay US\$5.9 billion of the debts to bring the country's outstanding debt to the Fund to the quota level of US\$2.8 billion. However, such

option would give unnecessary pressures for the country's balance of payments.

The decision brings an end to a 5-year 'love and hate' relationship between the government and the IMF. In 1998, both parties agreed on a 4-year term economic assistance program. The presence of the IMF during the period has been responded by both praises and criticism. The program was supposed to end in 2002, but was extended for a year. While some opinions considered the country still needs the IMF presence for another year, it would be politically unpopular to continue the program. A next step for the government is outlining the blueprint of the country's post-IMF economic reform agenda. The country should also prove now that it has already been capable enough to deliver credible economic policies.

## WHAT IS A POST-PROGRAM MONITORING?

When an IMF-assisted country ends the bailout program, it does not have to immediately repay the remaining debts to the Fund. However, until the country can bring down its IMF-debt to the level below the member quota, it must adopt a PPM arrangement. Indonesia's outstanding debt to IMF amounts to US\$9.2 billion, while the country's quota at the Fund is US\$2.8 billion. Hence, by default, Indonesia must enter the PPM.

Under the PPM scheme, an IMF team would visit the country twice a year to give unbinding assessments on the government's economic policy. Although unbinding, the Fund could publish its assessments, and let the market judge. Under the current scheme, the government's economic policy is outlined in the Letter of Intent (LoI). The LoI is drafted periodically in a quarterly basis (four times a year), and must be approved by the IMF Board of Directors, based in Washington, D.C., before the Fund's loan being disbursed. Approvals of LoIs have been used as the benchmark for market confidence, as well as the basis for the Consultative Group of Indonesia (CGI) and the Paris Club creditor nations to provide any new loan commitments or debt rescheduling facilities.

Alternatively, the government might choose to avoid PPM but would have to immediately repay the debts it owes

to the IMF. If the government chooses this option, it will have to pay at least US\$5.9 billion immediately to bring the country's debt to IMF to country's quota level of US\$2.8 billion. Relevant to discussions on the comparison between these two options are their implications on three aspects of economic policies: the government's foreign reserve, fiscal viability, and policy-making credibility.

Of these aspects, the least worrisome is foreign reserve. Currently, it remains strong at US\$34 billion. Under the PPM scheme, the government and may spread the repayment of US\$9.2 billion it owed to the Fund until 2010,<sup>1</sup> hence there will not be any sudden drop of the foreign reserve. Without PPM, the government will need to deplete about US\$5.9 billion for debt repayment to the IMF, putting our reserve still at US\$28.1 billion (more than nine months of import). Absent a major disaster with the BOP of the scale experienced early in the crisis, it is safe to say that the government will be able to maintain its BOP support function, even if it decided to avoid PPM and repay the IMF loans.

However, keeping the loans for another several years gives the benefit

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<sup>1</sup>According to the official press statement by the government, should the economic conditions in the following years permit, the elected Government in 2004 could opt for an accelerated payment of loan principal and interest to the IMF.



to gain returns from portfolio investments managed by the Central Bank. Currently, IMF charges a 2.8% interests per annum for the money it lends to the government. But the Central Bank gains 3.2-3.3% p.a. by investing the foreign reserves into various low-risk investments, such as bonds issued by foreign governments or corporate.

Meanwhile, the fiscal issue will mainly be an issue of debt management. Ending the IMF program means the government is no longer eligible to the debt rescheduling facilities from the Paris Club creditor nations, giving more pressure to manage budget deficit in the coming years.<sup>2</sup> Table 1 below estimates the financing gap in 2004 if the Paris Club debt rescheduling, which amounts to Rp27 trillion in 2003, is unavailable. Assuming 3.5% real GDP growth with a 9% inflation, a budget deficit of 1% of GDP, and the achievement of half of the 2003's privatization target, and a quarter of 2003's asset sales target (since most good state-owned enterprises and recapitalized assets would have been sold by 2004) while holding everything else constant, the financing gap amounts to around Rp52.4 trillion. Parts of this gap can be covered by some existing

<sup>2</sup>Paris Club's debt rescheduling is given only to a country having troubles in financing. The benchmark is that the country is under IMF program and receiving loans from the Fund. By ending the program, it means that Indonesia no longer receives IMF loans, hence it is no longer eligible for debt rescheduling facilities.

Table 1

**BACK-OF-THE-ENVELOPE  
CALCULATION OF  
BUDGET ESTIMATES (RP TRILLION)**

	2003	2004
<b>Gross Dom. Product</b>	1,940.0	2,182.5
<b>Deficit as % of GDP<sup>2</sup></b>	-1.8	-1.0
<b>Deficit</b>	-34.4	-21.8
<b>Domestic Financing</b>	22.4	-13.5
Domestic Bank	8.5	8.5
Non-Bank Domestic	13.9	-22.0
SOE Privatization	8.0	4.0
Recap assets	18.0	4.5
Bond transactions	-12.1	-30.5
Net issue	1.5	0.0
Repurchase	-13.6	-30.5
<b>Foreign Financing</b>	12.0	-17.1
Loans	29.3	29.3
Amortization	-17.3	-46.4
Principal dua	-44.3	-46.4
PC Rescheduling	27.0	0.0
<b>Financing Gap</b>	0.0	-52.4

Source: 2003 Revised Budget and CSIS Quarterly Report (May 2003)

funds, such as the investment funds (RDI), estimated at around Rp21 trillion by the end of 2002 (*Tempo Interaktif*, 29 January 2003) and the accumulation of the remains of previous years' budgets (*Sisa Anggaran Lebih - SAL*), whose exact number remains a mystery (CSIS Quarterly Report, May 2003).

Whatever gap remains needs to be financed by issuing more of either debts or government bonds, both domestically and internationally. At issue here is whether the government can get a favorable rate, especially for its bonds; and here, overall credibility



(and its effects on macroeconomic stability) plays an important role. The question, then, is whether the choice between PPM and no-PPM will significantly affect the government's credibility. We think that it will. Taking the no-PPM option might risk sending the wrong signals that the government intends to do whatever it wants irrespective of economic rationales. As such, without a strong and credible signal that the current and next government will be committed to reform, the no-PPM option is a risky option.

## POST-IMF ECONOMIC REFORM

The decision not to extend the present arrangement with the IMF brings the 5-year economic assistance program to an end. The decision had just ended the lengthy debate over the Fund's presence in Indonesia. But a most significant issue after that is the government's post-IMF economic reform strategy and agenda. The government said it is now drafting a "white paper" containing the blueprint of economic policies after the end of the IMF program. The "white paper" will be delivered in submission of budget revision on 15 August 2003.

The government said that the "white paper" would cover the areas of macroeconomic stability program, financial sector reform, and improvements of the investment climate, exports and job creation conditions. While the detail of the policies has

yet to be publicly released, the economic reform agenda should aim to tackle several issues:

- Fiscal sustainability, including foreign and domestic debt management;
- Banking and corporate restructuring;
- The recovery of real sector;
- Institutional reform including legal system;
- Social protection.

Policies outlined in the "white paper" should also be clear and have explicit timeline. It is important to win the market confidence. The market would not be convinced on statements, such as "improving legal system" or "improving banking system". What the market wants to hear are policies like "executing court decisions on corruption cases" or "reaching the Capital Adequacy Ratio (CAR) level of 10% for domestic banks by the end of the year".

More than delivering a good and acceptable post-IMF economic reform strategy, the government must also prove that it has a commitment to undertake the outlined agenda without the presence of IMF. Again it will be a question on credibility.

## THE IMF IN INDONESIA: THE DEBATE REVIEWED

During five years of economic assistance program to Indonesia, the role of IMF has sparked many controversies.

The opponents of the extension argue that the presence of IMF has not helped much to bring the country out of the economic crisis. Even it has cost the country more. It was indicated by the fact that during five years under the IMF program, the economy has only been growing at 3-4% per year. Structural recovery has been very slow, and the foreign investors' confidence has yet to fully recover. The IMF has also been criticized for being too pushy in dictating the policies, and considered to have misjudged, miscalculated the real situation in Indonesia, which led to incorrect policies suggested.

Such arguments may be either true or not. Nevertheless, we are not in the position to prove that had the IMF not come to Indonesia, back in 1997, the country's economic performance could have been better than at present. But there is something missing in the logic here. Asking for the IMF assistance is one thing, but being committed to the settled agreement is another thing. Many times the IMF delayed the loan disbursement because the government failed to perform some policy actions or failed to achieve the indicative targets.

Hence, it is irrelevant to debate how the economy would perform with or without the IMF. We can only evaluate how serious the government is in undertaking the economic reform. University of Indonesia's economist Chatib Basri once illustrated the situ-

ation when Abdurrahman Wahid was the president, and Rizal Ramli was the Chief Economic Minister (2000-2001), the relationship between the government and the IMF was in the lowest point. Many policies outlined in the Letter of Intent (LoI) were not performed, and the IMF delayed its loan disbursement for more than a year. That means, during the period, the role of the IMF in the Indonesian economy was not significant. Still the economic performance was not much different, as compared with the present.

The illustration suggests that the presence of the IMF is only a secondary factor for the economic performance. The primary factor is the seriousness of the government. But while the main problem lies on the secondary factor, oddly the secondary factor is the one to blame.

The IMF has also been criticized for being too authoritarian in drafting policies outlined in the LoIs. However, Rizal Ramli—one of the opponents of the IMF—once claimed that when he was the Chief Economic Minister, he could make the IMF included his idea, which was called "10 economic programs" in the LoI in 2000. Meanwhile, economist Arif Arryman, an assistant to Rizal Ramli at the time, once mentioned that the IMF could agree not to mention the name of banks to be sold in the LoI, to avoid the market price of the banks drop. Such situations may illustrate that there are rooms for negotiation with the IMF. The question



is whether the government had made use of the rooms with good, convincing arguments.

It is not to say that the IMF is free from any sins. Many of its policy prescriptions have been bad, or at least questionable. Most of the problems have arisen since the IMF failed to understand the socio-political situation in Indonesia that has distorted economic theories from the reality, for example, the closure of 16 banks in 1997. It was a good policy in paper. But because it was taken at the time when the economic crisis started to become a political one, the effect was a serious deterioration of public confidence on the domestic banking sector. As the result, banking sector recovery had become more difficult.

However, a devil's advocate --as some people call it-- it may be, one important role of the IMF for the country is making sure that the government is on track on economic reform. Practically, it is the only institution that could 'step on the government's toe', quoting economist Faisal Basri's term, to be committed to the economic reform agenda. In the lack of a strong,

credible government and a consolidated civil society in which the check-and-balance mechanism is functioning well, sometimes an external pressure is needed to push for economic reform.

Looking back to the 1997-98 era, it was the IMF that became powerful instruments to strip the rent-seeking power of Soeharto's oligarchy. Through the LoIs, the monopoly powers of the cronies were reduced, the notorious clove marketing agency (BPPC) was eliminated, the ridiculous national car project was halted, and the off budget expenditures were made transparent. At a level, those made Soeharto angry and called for the rejection of the IMF, arguing that the LoIs were too liberal and against the state constitution.

We could stop now and think, what would it be had Soeharto really sent the IMF home at that time? But again, that would be an unproductive discussion. What are relevant now are these two issues: the quality of the government's post-IMF economic reform, and how to guarantee that those agendas would be consistently implemented.

# The Aceh Conflict: The Long Road to Peace

S. Wiryono

## THE BEGINNING OF AN INVOLVEMENT

IT was in early January 2002, with the fasting month of Ramadhan having just come to a close, when Indonesian Foreign Minister Hassan Wirajuda asked me whether I was willing to accept the position of negotiator on the side of the Indonesian Government on the problem of Aceh. The negotiations had been launched two years earlier with some encouraging results, but had been in suspension for about seven months. I accepted the offer as a matter of patriotic duty, but with a great deal of trepidation. I actually began assuming my duties as negotiator when the suspended talks resumed in Geneva on 2 February 2002.

## HISTORICAL BACKGROUND

Aceh has a history of militancy, having fought the Portuguese in the 1520s and the Dutch from 1873 to 1913, and having waged an Islamist uprising against the Republic of Indonesia in 1953. In that uprising, the

rebellion, called *Darul Islam*, aimed at establishing an Islamic republic all over Indonesia, which was also sought by religious militants in West Java and South Sulawesi. It came to an end in 1962 when, after negotiations, the Soekarno Government gave assurances that Aceh would be given status as a special region, with broad autonomy with regard to religion, customary law, and education. Over the years, however, that pledge has not largely been fulfilled.

The current secessionist rebellion in Aceh began on 4 December 1976 when Muhammad Hasan Ditiro declared Acehnese independence. Ditiro and his closest followers had been involved in the Darul Islam rebellion of 1953 but this time their uprising, to which they gave the name *Gerakan Aceh Merdeka* (GAM) or Free Aceh Movement, was of a clearly secessionist intent. Not long after that declaration of independence, the forces of the GAM began attacking government troops, only to reel back in the ensuing government counter insurgency operation. By 1983 the GAM forces had



been defeated in the field and Ditiro had fled to exile abroad where he and some of his followers eventually became a Swedish citizen.

During most of the decade of the 1980s the GAM recuperated, rationalized its political status, and strengthened its military arm, *Angkatan Gerakan Aceh Merdeka* (AGAM). During this period, some 400 Acehnese cadres were reportedly sent to Libya for military training. By 1989, GAM felt strong enough to challenge the Indonesian Government once more, attacking troops, civilian personnel and suspected informers. The Government responded with a massive military operation and repression.

By 1992, it appeared that the Government had the situation under full control. Military oppression characterized by widespread violation of human rights, however, fed public resentment against the Government in Jakarta. The human rights violations in Aceh came to public light soon after Soeharto bowed out of power in the political tumult of May 1998. Pressured by a public outcry all over Indonesia at the atrocities and human rights violations in Aceh, the Indonesian Armed Forces Commander-in-Chief General Wiranto apologized for the excesses of the military from 1989 to 1998 and lifted Aceh's status as an area of military operations, promising substantial troop withdrawal from the province. Peace did not come, how-

ever, as the GAM, taking advantage of the demoralization of the military, launched an offensive. Armed confrontation resumed.

In mid-1994, the GAM organization split when Kuala Lumpur-based officials broke off from the Sweden-based leadership, which includes Hasan Ditiro. Apparently the main difference between these two factions was the form of government that Aceh would assume after independence. Ditiro favors a monarchy, with himself as Sultan, while the Kuala Lumpur-based group favors a modern Islamic republic. Ditiro, who claims to be a descendant of the last Sultan of Aceh, has secured the loyalty of most of the GAM forces operating in the province.

## A WINDOW OF OPPORTUNITY

During the administration of President Abdurrahman Wahid, there was a window of opportunity for peace in Aceh, which both sides were able to seize, for a while at least. The Wahid administration's overtures for dialogue received positive response from the GAM faction led by Hasan Ditiro. In May 2000, representatives of the Indonesian Government and the Free Aceh Movement signed in Geneva a document called "*Joint Understanding for Humanitarian Pause for Aceh*" the stated objective of which was to allow the free flow of humanitarian aid to a population in dire need of it.

Reached after a series of confidential talks with the mediation of the Henri Dunant Centre, an international humanitarian NGO, the Joint Understanding was an important confidence-building measure that created common ground between the two sides on which further dialogue could be built. Although this development was welcomed by the war-weary people of Aceh, it was less than satisfactory to many circles in Jakarta. For one thing, parliament was not consulted on this matter, nor was there any discussion in the press or anywhere else in which experts and academics could have contributed their views.

The negotiator of this agreement on the Indonesian side was Dr. N. Hassan Wirajuda, then Permanent Representative of Indonesia to the UN in Geneva, who would later become Foreign Minister of Indonesia. The Government took care to explain that Dr. Wirajuda, while representing the Government, was not negotiating in his capacity as Permanent Representative to the UN in Geneva. This explanation was apparently given to reduce criticism that by negotiating with the GAM, the Government had made a blunder and the GAM had scored a diplomatic victory, since the act of negotiating with the GAM implied recognition, putting the GAM, at least theoretically, on an equal footing with the Government. To a number of legislators, some academics and a few in the media, the talks in

Geneva represented an internationalization of the Aceh problem. This negative reaction becomes easier to understand when cast in the light of what many Indonesians have seen as the consequences of the internationalization of the problem of East Timor.

Nevertheless, the administration of President Abdurrahman Wahid persevered in pursuing dialogue. That dialogue, in spite of many difficulties brought about partly by the situation on the ground, proceeded steadily forward so that in January 2001 both sides reached a "*Provisional Understanding*" that contained various provisions that would make possible future arrangements to check the violence and carry out confidence-building measures. By the middle of the year, the government side put on the table the offer of special autonomy, and both sides agreed on an eventual holding of an all-inclusive informal dialogue of all sectors of Acehnese society, including the GAM. But for about seven months after that, from July 2001 to February 2002, dialogue could not proceed mainly because of difficulties on the ground brought about by an increasing frequency of skirmishes. Meanwhile, President Megawati who has a more nationalistic outlook than Wahid, had taken over the reins of government, and she had appointed Indonesia's negotiator, Dr. Hassan Wirajuda, as Indonesia's Foreign Minister.



## SOME ASPECTS OF THE PROBLEM

Within the Southeast Asian region and among various countries with which Indonesia has bilateral relations, as well as in international fora like the Non-aligned Movement, the Organization of the Islamic Conference, the European Union, etc., there is strong support for Indonesia's sovereignty and territorial integrity, especially with regard to the question of Aceh and even Irian Jaya. The GAM, on the other hand, has no external support for its claim to statehood except perhaps from some NGOs. It did at some point received military training support from Libya but not much else. To some degree, the GAM is in control of a force and enjoys some support, which is difficult to estimate, from the people of Aceh. There is widespread concern for the continuing violence resulting in frequent violations of human rights and producing a great number of internally displaced persons, while crippling the socio-economic life of Aceh. This concern translates into domestic and international pressure on both sides to bring the conflict situation to an end, to establish durable peace and rebuild the socio-economic life of the province.

A good number of observers have identified one extremely formidable obstacle to peace in Aceh, that is, a situation of widespread corruption that gives everyone involved an economic

motive for leaving the problem unsolved. There is reportedly a great deal of smuggling of luxury goods going on in the free port of Sabang. Extortion and protection racketeering by both the military and the GAM guerillas have been observed to be endemic from one end of the province to the other. Weapons from foreign sources are regularly brought ashore by fishing boats in a thriving arms trade that keeps the GAM and other groups of a more criminal nature well armed. The national government can to a large extent curb the corruption by simply making provincial officials and other authority figures more accountable, but such a crackdown may have its own destabilizing effects.

## THE SITUATION IN 2002

By the time that I was entrusted with the task of leading the Indonesian side of the dialogue, some 10,000 individuals have died as the course of the conflict and killings were averaging five a day. Enormous damage had been wreaked on the economic and social life of this resource-rich province. The people of Aceh were weary of the conflict. Having succeeded to some extent in solving the conflict situation in the Malukus and Central Sulawesi through the Malino peace processes, the Government had a sense of momentum that it could soon enough solve the Aceh problem as well. The Government, both

the executive and the legislature had publicly affirmed in various statements and documents that the best solution was through dialogue within the framework of a comprehensive approach, which also included the use of military and police work. In effect, it was a two-track policy.

In spite of that two-track policy, there was already a widespread perception in the government, including parliament, that the Indonesian armed forces had the upper hand in Aceh. Until today, many believe that there is no need to negotiate with a losing and weakening secessionist movement that has no international support. *There is also belief that there is only one thing to do about a separatist movement and that is to crush it, period.* In this kind of atmosphere, dialogue has proven difficult to pursue. Nevertheless, I proceeded to do what I could to get a dialogue going with the GAM. I interpreted my mandate to be the continuation of the negotiation process with a view to consolidating what has been achieved so far in a document—if possible in the form of an “interim agreement”—that would cover both the points of consensus and the points for further elaboration so that succeeding meetings of the two sides will have a foundation to build on. As previously agreed, the two sides formed a Joint Council for Political Dialogue with five internationally eminent individuals acceptable to both sides serving as advisors.

Having been briefed on the situation in Aceh and on previous developments, the negotiator drafted a “Proposed Guidance” for his own use in the negotiations. The Proposed Guidance recognized the desire of the Acehnese people to administer themselves peacefully in freedom and democracy. This would be achieved through three main courses of action. First, the conflict would be ended and peace established over a transitional period, and special autonomy would be accepted as the final solution to the conflict. Second, during the transitional period, there would be cessation of hostilities, an intensive confidence-building process would take place, and socio-economic life in Aceh would be normalized with humanitarian aid and economic assistance from the Government of Indonesia and the international community. And third, an all-inclusive dialogue among all elements of Acehnese society, including the GAM, would serve as the consultative forum for achieving a negotiated peaceful settlement to the Aceh problem on the basis of the Nanggroe Aceh Darussalam (NAD) Special Autonomy Law, a legislation passed during the tenure of President Wahid granting special autonomy status to the province of Aceh. After conclusion of that all-inclusive dialogue, preparations could then be made for general elections in Aceh to enable GAM followers to participate in the Indonesian national elections of 2004.



In the February 2002 meeting, the Negotiator explained to the Henri Dunant Centre officials and all the advisors the ideas contained in the Proposed Guidance. They generally responded positively to the Proposed Guidance, particularly since it allowed dialogue to proceed without explicitly discussing the sensitive issue of the GAM'S demand for Acehese independence. The only source of difficulty was the core of the Government's position and that was the acceptance by the GAM of the Government's offer of autonomy spelled out in the NAD Law. Its acceptance by the GAM would have implied abandonment of its demand for independence.

The two sides discussed intensively during that February meeting but in the end, the GAM side was not ready to sign the joint statement that would have been the outcome of the meeting, as it sought more time to consider the offer of autonomy. And since the draft joint statement could not be jointly issued by the two sides, it was agreed that the facilitator, the Henri Dunant Centre, would issue it on their behalf. The text of that statement clearly stated that the two sides agreed *"to use the NAD Law as a starting point for discussions"* and *"to a period of confidence-building in which they will cease hostilities and then move towards democratic elections in Aceh in 2004."* The document therefore served as a road map for the peace process ahead, stipulating a cessation

of hostilities, an all-inclusive dialogue and elections.

## THE MAY 10 AGREEMENT

The subsequent meeting between the two sides held in early May 2002 resulted in the formalization of the February document issued by the Henri Dunant Centre. On 10 May 2002, they signed a Joint Statement with essentially the same content as the February document. Difficulty arose when the two sides interpreted the text differently. The Government had thought that it had secured commitment of the GAM'S "acceptance of the NAD Law as a starting point," while the GAM seemed to understand it only as the first thing to be discussed. One of the principal spokesmen of the GAM side, Mr. Sofyan Ibrahim Tiba, upon his return to Aceh, firmly denied that the GAM had accepted the NAD Law. What made matters worse was that armed elements claiming to belong to the GAM started attacking government facilities, particularly electric pylons, and in the process killing a considerable number of innocent civilians, including women and children. The military responded by bringing in more troops and intensifying anti-insurgency operations. This followed a pattern where every time both sides reached an agreement, elements on the ground would issue statements repudiating what had been agreed on take hostile action that set back the dialogue process.

Thus, a third meeting, which should have taken place in June, did not materialize as the deteriorating situation on the ground made negotiations untenable. On 19 August, the Indonesian Government announced a new policy on Aceh: it gave the GAM until the end of the fasting month of Ramadhan, which falls around 7 December 2002, to accept the offer of special autonomy as a prerequisite for future dialogues, or face the full brunt of Indonesia's military power. In fact, the dialogue process is now in suspension, without any assurance that the GAM would return to the negotiating table. Meanwhile, the violence has escalated and continues to claim more lives. An attempt was made recently on the life of the governor of the province. Just before the end of August 2002, however, the Government softened its stance a little with the announcement by the Coordinating Minister for Political and Security Affairs that "we expect to have another round of talks (with the GAM) in September, perhaps not official ones, but we will continue to pave the way for a peaceful settlement."

In early September 2002 the Government of Indonesia submitted a draft agreement for the cessation of hostilities to the Henri Dunant Centre and the advisors. The Centre and the advisors subsequently made amendments to the draft, which means that they adopted it so that it could serve

as basis for further dialogue between the Government of Indonesia and the GAM. And that was precisely what happened: the draft as amended and consolidated by the Centre was negotiated with the representatives of the GAM and in a series of meetings of indirect negotiations the two sides were facilitated by the shuttle diplomacy of the HDC held in Singapore, Pans, Geneva and Stockholm. That process took several weeks. On 19 November 2002, the Centre announced that both sides had committed themselves to reach an agreement. Although a few issues still had to be resolved, an agreement on cessation of hostilities was planned to be held on 9 December 2002. Essentially, the draft agreement called for the formation by the Government of Indonesia, the GAM and the Henri Dunant Centre to form a 150-member Joint Security Committee to monitor the cessation of hostilities, to investigate violations and to take measures, including sanctions, to restore calm. The Nanggroe Aceh Darussalam (NAD) Special Autonomy Law would be the starting point of an all-inclusive dialogue among the Acehnese leading to provincial elections in 2004. The unresolved issues included such details as the timing and manner of the laying down of arms by the GAM, and the counterpart measures to be taken by the Indonesian security forces. The whole process is designed to take the guns out of politics.



## A POSITIVE TURN OF EVENTS

While the Henri Dunant Centre sounded confident that the signing would take place as scheduled, there were actually many hitches that, up to the last moment, had to be overcome. It greatly helped that the international community took an interest in the process and demonstrated its support by holding in Tokyo on 3 December 2002, six days before the scheduled signing of the agreement, a conference of donor countries led by Japan and the United States and international funding agencies to raise funds for the reconstruction of Aceh after both have signed the Cessation of Hostilities Agreement. Other countries that participated in that conference were Australia, Canada, Denmark, France, Germany, Indonesia, Qatar, Malaysia, the Philippines, Sweden, Switzerland, Thailand and the United Kingdom. Also in attendance were the European Commission, the Asian Development Bank, the World Bank, the UN Development Programme and the Henri Dunant Centre. The GAM was invited to the conference but did not attend.

The holding of the conference was a manifestation of the concern of the international community at the continuing instability of Indonesia, which was partly due to the problem of Aceh. *If the problem of Aceh as well as those of Papua, Maluku and several other provinces could be altogether solved to the months ahead,*

*it would be the tremendous relief of neighboring countries that had been anxious at the adverse effects of the internal conflicts in Indonesia on the general stability of the region. For Indonesia, the solution of these internal problems would to a large extent restore its standing in the international community and among foreign and domestic investors.*

It was agreed at the Tokyo Conference on Peace and Reconstruction in Aceh that once the agreement was signed, a multiagency mission would be sent to Aceh to assess the requirements of the social and economic rehabilitation of the province. The participating countries and institutions would then raise the funds needed for humanitarian assistance, support for the demobilization of combatants, short term high-impact community-driven investments, improvement of health and education facilities and infrastructures building. The Consultative Group on Indonesia (CGI) would coordinate the donors while local communities and civil society will be engaged to ensure that the funds reach the people as quickly as possible, with accountability and transparency. The idea was to ensure that the people would feel that they were immediately reaping "peace dividends" and thereby the peace process would be strengthened.

The Cessation of Hostilities Agreement (COHA) was signed in Geneva on 9 December 2002. I was privileged, as the Indonesian Government negoti-

ator, to sign the Agreement on behalf of my Government. My counterpart on the GAM side was Dr. Zaini Abdullah. In my remarks on that occasion, I pointed out that this was a modest but significant victory for both sides and far all that were interested in peace, but not yet the final victory, for which we still had to work hard. We still had to make the Cessation of Hostilities work so that durable peace could be attained in Aceh and that was the hard part. Important new details of the Agreement include the provision of a two-month grace period during which both sides would demonstrate their commitment to peace by not increasing their forces and re-locating these forces to defensive positions. Demilitarized zones would also be designated during the period. After that grace period, the GAM would designate where it would place its weapons. The placement of weapons would be completed in five months. After that preparations would be made for the all-inclusive Aceh dialogue during which they would negotiate on the modality for the review and possible revision of the NAD law.

By January, it was already apparent *that the road to peace would be a bumpy one*, especially during the first two months. Much would depend on the skills and wisdom of the Joint Security Committee under Major General Thanungsak Tuvinan of Thailand and his deputy, Brig. Gen. Nogomora Lomodag of the Philippines. As of 30 December 2002 there were

already some 50 incidents of fighting between the GAM troops and the Indonesian security forces. From the moment the Agreement was signed up to this writing, the body count has dropped considerably but it has been going up lately. There was also the problem that resulted from a lake rejection by the GAM of the Filipino observers in the Joint Security Committee: the GAM contends that because the Philippine Government is fighting a Moro secessionist movement and because Indonesia has brokered a peace agreement with another secessionist group in 1996, the Filipino monitors cannot be impartial. The matter was soon smoothed over, with the Filipino monitors who were already in place remaining where they were posted and the rest replaced by Thai monitors.

And yet the general effect of the signing of the Agreement had been widespread optimism verging on euphoria all over the province — and that is because the Agreement is already perceived to be a *peace agreement*. The fact is that the guns are not yet altogether silent and it will not be until the end of July that these guns will be removed from politics. But *the people believe that then already have peace in their hands* and would not let go of it. Sick and tired of decades of armed conflict during which more than 10,000 persons, mostly civilians, died, the Acehneses want peace that badly. With hopes and expectations raised so high, the



risk is that *if the peace process failed, the letdown could be very severe.*

In Jakarta, the signing of the Agreement was greeted with approval but with a more cautious sort of optimism. No sector of society and no faction in parliament came out critical about the agreement. *President Megawati Soekarnoputri herself demonstrated her Government's commitment to the Agreement by visiting Aceh soon after it was signed.* GAM units are heading back to their bases. A multi-agency United Nations team visited Aceh in order to assess the requirements of the rehabilitation of the province. The initial finding of the team was that the province was in dire need of financial aid to rebuild school and health facilities destroyed in the course of the conflict. In Jakarta, the Government organized a team to distribute humanitarian aid. The Government also pledged to give priority to the hundreds of thousands of Acehnese who had been displaced during the conflict. Within the month, the Joint Security Committee, which monitors the cease-fire, was partly deployed. There was a dramatic reduction in the incidence of killings in the province. These positive developments could have gained tremendous momentum — but that did not happen. Instead, the process got bogged down and at one point it became difficult to see how it could still go forward.

It did not take long before the Indonesian military and the GAM ac-

cused each other of cease-fire violations. There were press reports of civilians intimidating members of the Joint Security Committee, a charge that the militant denied. At any rate, for their safety, the monitors were withdrawn from the field. The Government complained that the Committee had become ineffective in the field because of the negative statements of GAM personalities. In fact the GAM was brazenly holding pro-independence rallies and carrying out a public disinformation campaign to promote a public perception that the final result of the implementation of the agreement would be independence for Aceh. It also undertook heavy recruitment in the villages to swell the ranks of GAM fighters and appointed new officers of its fighting force. It smuggled in weapons to am that expanded fighting force. At the same time, it continued to build and expand its political structure in the villages, which competed with the provincial government for administrative control of the province. This underground government went so far as to collect what it calls a "Nanggroe tax." This was, of course, *a form extortion and a crime.* The Government also noted that with very little time left before the end of the demilitarization phase of tire implementation of the agreement, there was no indication of the system, plan and process of placement of GAM weapons, which would be overseen by the HDC. This greatly damaged the HDC's image. With very little time left to act, it was

regarded as highly improbable that the GAM could still comply with the provision on the placement of GAM weapons as stipulated in the agreement.

The Government then registered a strong protest with the Henri Dunant Foundation, charging that the GAM was in material breach of its obligations under the COHA. On this basis it demanded the immediate convening of the Joint Council, which is composed of high officials of the Government, the GAM and the HDC. The Joint Council was created by the COHA itself to settle disputes arising from its implementation that could not be resolved by the JSC created by the agreement. The demand for a meeting of the Joint Council was conveyed to the HDC in the early part of April 2003 on what the Government called a last-ditch effort to save the COHA.

Soon after that, Indonesian President Megawati Soekarnoputri sent a Special Envoy to the Prime Minister of Sweden to formally inform the Swedish Government that a number of its citizens, referring to Di Tiro and some of his prominent lieutenants, were engaged in rebellion and other criminal activities that have caused enormous loss of lives in a friendly country like Indonesia. The Swedish Government responded by requesting for more concrete evidence to back up Indonesia's grievous allegations. Indonesia seems to be preparing to accommodate this request.

Initially, the GAM responded to the Indonesian Government's demand for a convening of the Joint Council by sending a letter indicating its decision not to attend such a meeting. The Government at once started preparing for military operations in Aceh, as it seemed that the process toward peace was falling apart. In mid-April, however, the GAM communicated through the HDC that it was ready to attend the Council meeting and the Government welcomed this change of mind. They still had to agree, however, on the date and place of the Joint Council meeting. The Government proposed Tokyo. The GAM wanted it to be held in Geneva. The Government reluctantly agreed and set it on 25 April, a Friday, considering that in the past the GAM preferred to meet on weekends. The GAM indicated its agreement but not long after that, changed its mind again. The Government offered a compromise where the opening formalities would be held on the 25th with the respective advance parties in attendance, and the actual discussions will be held on the 26th and the 27th. But, for no clear reason, the HDC could not persuade the GAM to agree to this compromise. The GAM would agree to meet only on the 27th, a Sunday but what could be accomplished in only one day when there were so many sensitive and complex issues to straighten out? The HDC was not able to bring the GAM to the meeting, so it could not be held.



The Government had taken all pains to be flexible even when its patience was stretched to the limit. On the other hand, the GAM was not only inflexible without any clear reason, it also displayed a streak of obstructionism and disdain for the Government's demonstration of goodwill.

The big question now is: What next? The answer may be derived from a consideration of the past behavior of the GAM. Since negotiations began in early January 2000, the GAM's behavior has followed a pattern of perfidy. It would accept an arrangement, such as the humanitarian pause but would use it only for the purposes of consolidating its forces, only to resume fighting. Nvlien it would be confident that it had sufficiently gathered political and military strength. On the other hand, the Government's behaviour has always been consistent with its statement of 19 August that it would adhere to a strategy of exhausting all peaceful means before deciding on an "appropriate action," which many would interpret as a military operation.

The Joint Statement of 10 May and the COHA of 9 December are not perfect documents but these constitute a sufficiently clear road map; with the acceptance of the NAD law as a starting point, followed by cessation of hostilities, an all-inclusive dialogue and finally the election of 2004. While the precise format and schedule of the all-inclusive dialogue

are yet to be decided, the election specified in the COHA is clearly the election in Indonesia in 2004. There is no way the wording of the COHA could be interpreted as pertaining to a referendum or independence.

The fact is that the fundamental commitment of both the Government and the GAM is expressed in the pre-ambular section of the COHA, which states that "the GOI and GAM share the common objective to meet the aspirations of the people of Aceh to live in security with dignity, peace, prosperity and justice." So, while the HDC-facilitated talks are important, they do not represent the heart of the matter. Their shared mission is *not to find the road to peace, but to make peace the way to achieve their common objective*. And the only way to achieve that common objective is to adhere to the letter and spirit of the COHA and to sustain the focus on the common objective.

By exercising patience and flexibility in the face of the GAM'S intransigence and arrogance, the Government believes that it has secured the higher moral ground. If it must now reformulate its policy on Aceh in the face of GAM's unwarranted behaviour, it is important that it must do so in a way that it keeps its hold on that higher moral ground. The Government, therefore, can take either of two options: it can undertake some kind of military action, or it can retry the peace process.

Resuming the peace process does not appear to be a politically attractive option for some, while on the other hand, the view that peace should be endeavored at all cost has been strongly expressed by many prominent politicians, ulemas and Acehnese in general, but as the agreement provides for a five-month period during which the placement of arms is to be accomplished, theoretically the Government still has the option to wait until after 9 July, which is the deadline for the placement of the GAM's weapons, before it can be justified in carrying out a military operation in the province. As of this writing the debate is still ongoing.

When a decision is finally made to take military action, operations should be carefully planned so that what is waged is not war in the traditional sense but a *"humanitarian war"* that is based on a recognition that the exceedingly complex political situation in Aceh cannot be resolved through military force alone. Moreover, there is the risk that military action may backfire if sizeable civilian casualties are incurred. Hence, the military operation should be designed not only to win battles and skirmishes but primarily the hearts and minds of the people of Aceh. The spirit of the time demands that even the justified use of military force must take all precaution against "collateral damage." A large number of civilian casualties could engender a new sense of grievance on the part of the people of Aceh, thereby frustrating the attain-

ment of the objectives of a humanitarian war. Indeed, it is imperative that the people of Aceh support the operation at least to some extent, and should therefore be conducted in such a way that it is perceived as not in disregard of their interests and their lives. The humanitarian aspect of the operation should be of primary consideration.

This means that it should not be an effort of the military forces alone. Social, political, economic and, indeed, public relations considerations should be integrated into the substance of the operational plan, and should involve appropriate operational contributions from the government agencies concerned with the delivery of social services. This means that the flow of humanitarian aid to communities that suffer collateral damage will be as important as the availability of ammunition and other war material. Above all, military personnel in the field must not only actually respect the human rights of the people of Aceh even in the heat of the fighting, but must also be seen as doing so by an observant world that will be keenly monitoring the progress of the operation.

Above all, the effort should be as brief as possible. As the Chinese military philosopher Sun Tzu put it, *"There is no instance of any nation having gained a benefit from prolonged war."* Certainly not if it will take another 26 years, as it has happened in Aceh.



# Overview of the Political Dimension of ASEAN's Security\*

C.P.F. Luhulima

## AN INTRODUCTION

A number of major goals were set out in the ASEAN Declaration in Bangkok on August 8, 1967. *First* is to reconcile intra-regional strife, which characterized Southeast Asia at the time in the form of border and territorial disputes, ethnic conflicts and animosities, religious prejudices, and the fear of smaller states of the bigger states. *Second*, to manage it and create a South-east Asian regional order on the basis of the social and economic systems of each member country and "the territorial status quo." Both goals are to be achieved by way of a *third* goal, which is to speed up "the economic growth, social progress and cultural development in the region". This goal is indeed more pronounced than the

goal to "promote regional peace and stability". Nonetheless, ASEAN's founding fathers were confident that economic and societal development, on the one hand, and peace and stability on the other, were tightly linked. This linkage was expressed time and again in their speeches and in the agreements they signed since the Association's establishment. They are further determined, and this is their *fourth* goal, "to ensure their stability and security from external interference in any form or manifestation" to "preserve their national identities in accordance with the ideals and aspirations of their peoples".

The three major goals of regional political and security endeavours in Southeast Asia were subsequently cast into four instruments for political and security build-up: *The ASEAN Declaration*, *The Declaration on the Zone of Peace, Freedom and Neutrality* which was primarily meant to secure the recognition and respect for Southeast Asia as such a zone, *The Bali Concord* and *ZOPFAN's legal instrument The*

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\*Presented at the Forum Diskusi "Indonesia dan Masa Depan ASEAN," Hotel Novotel, Bogor 24-25 March 2003 organised by Badan Pengkajian dan Pengembangan Kebijakan Departemen Luar Negeri Republik Indonesia.

*Treaty of Amity and Cooperation in Southeast Asia* which was meant to promote perpetual peace, everlasting amity and cooperation among the Southeast Asian nations.

## THE POLITICAL DIMENSION OF ASEAN'S SECURITY

### Zone of Peace, Freedom and Neutrality

It was in 1971 that ASEAN succeeded in institutionalizing Southeast Asia as a security community, or as some analysts also suggest *a community of security interests*, when the foreign ministers signed the *Declaration on the Zone of Peace, Freedom and Neutrality* (ZOPFAN). Changes in great power relations made it necessary for ASEAN members to assess "the intentions of the great powers but also to get to know our individual relations to new developments and rapid changes in our area."<sup>1</sup> The ZOPFAN Declaration is the expression of ASEAN's unwillingness to allow the major countries in the Southeast Asian region: China, Japan, the Soviet Union and the United States of America unlimited involvement in the region. ASEAN has struggled relentlessly for the recognition and respect of the major powers for Southeast Asia as a zone of peace, freedom and neutrality while intensifying cooperation among themselves as a prerequisite to contributing to their "strength, solidarity and closer relationship" in the effort.

Some 14 guidelines were submitted to serve as guidelines for the formulation of a "code of good conduct" in the region.<sup>2</sup>

### The Treaty of Amity and Cooperation and the Manila Protocol

ASEAN soon realised that for a zone of peace, freedom and neutrality to work in the region, it needed a code of conduct, a legal instrument to promote the growth of peaceful intra-Southeast Asian relations. The Bangkok Declaration and the fourteen guidelines became the fundamentals for the formulation of a legal instrument of Southeast Asian regionalism: It is not supposed to hamper "the independence, sovereignty, equality, territorial integrity and national identity" of all nations. It is to guarantee that each country in the region shall have the right to "lead its national existence free from external interference, subversion or coercion"; that there will be "non-interference in the internal affairs" of one another; that "settlement of differences or disputes shall be conducted only by "peaceful means"; and that the "threat or use of force" shall be repudiated, and that "effective cooperation among themselves" shall be fostered.

These rules of conduct re-affirm the characteristic of ASEAN's regionalism: ASEAN is and will remain a dependent variable, a variable that depends on the political will of each



member country to comfortably release a number of relevant components of their sovereignty for the construction of organized regional life in South-east Asia. Hence, the level and weight of ASEAN cooperation is very much decided by their vicissitudinous sensitivities to the issues of sovereignty. The regional level and weight of interaction can thus only increase if member countries are willing to reduce those sensitivities for a greater benefit to themselves.

These guidelines simultaneously provide for internal as well as for external security. If a dispute between countries in the region were to occur which is very likely to disturb regional peace and harmony, and if the parties to the dispute were unable to resolve it, they would constitute "as a continuing body, a High Council comprising a Representative at ministerial level from each of the High Contracting parties to take cognizance of the existence of disputes or situations likely to disturb regional peace and harmony."<sup>2</sup> This method of preventive diplomacy refers succinctly to paragraph 33 (1) of the Charter of the United Nations. The stipulation is, however, only valid if the parties to the dispute agree to apply the instrument to their dispute. On the other hand, parties to the dispute should be persuaded to take the initiative in finding a solution to their disputes through peaceful negotiations and in the shortest time possible.

However, despite the Treaty of Amity and Cooperation, conflict prevention in ASEAN is predominantly informal in nature. It is the strict adherence to intra-ASEAN norms of non-interference and non-use of force in inter-state relations as well as the time-consuming practice of consultations and accommodation that have enabled ASEAN member countries to discharge the possibility of any serious military escalation of intramural disputes. ASEAN's preference is thus for informal approaches in solving conflicts, to place emphasis on relationships rather than on formal structures; that consensus building is a crucial prerequisite, and that there is a general distrust for "Western" solutions.

On December 15, 1987 ASEAN made amendments to paragraph 14 and 18 of the Treaty of Amity and Cooperation to enable Papua New Guinea to become a party and by default the "States outside Southeast Asia." Countries outside Southeast Asia can also become a party to the Treaty "by consent of all the States in Southeast Asia which are signatories to this Treaty" (*Manila Protocol*).

ASEAN will indeed have to consider whether the Treaty and its 1987 and 1998 amendments can be provided with additional safeguards against corrupt practices and raised as the basis for a system of preventive diplomacy in the wider East Asia region. The ASEAN Regional Forum (ASEAN Se-

curity Forum), is a clear example of internationalizing ASEAN's primary security concerns in which the constructive engagement of external powers is being solicited to serve the vital interests of the Southeast Asian countries. Non-Southeast-Asian countries can only sit in the High Council "in cases of disputes to which it is directly involved". This is a sharpening of Article 16 of the Treaty, which allows States outside the region to involve themselves legitimately in Southeast Asian affairs. Earlier the essence of the Treaty has also been applied to the South China Sea. The Declaration of Principles of the South China Sea signed by the ASEAN Foreign Ministers in Manila (July 1992) persuades all parties to "apply the principles of the Treaty of Amity and Cooperation as a base for formulating a code of international conduct in the South China Sea" and "invite all parties to abide by the Declaration of Principles."

### **Southeast Asia as a Nuclear Weapon-Free Zone**

The Treaty of a Southeast Asia Nuclear Weapon-Free Zone the Treaty of Amity and Cooperation in Southeast Asia are key component of ZOPFAN and will thus contribute towards the strengthening of the security of member states and as a corollary towards enhancing international peace and security. They are the only legal products ASEAN signed with a view to regional security. All other ASEAN

agreements do not have a legal character. The principles and objectives for nuclear non-proliferation which were adopted at the 1995 Review and Extension Conference of the parties to the NPT and the cooperation of all nuclear-weapon states is important for the maximum effectiveness of the zone and its relevant protocols. The SEANWFZ treaty came into force on 27 March 1997.

### **Reactivation of ZOPFAN**

The reactivation of ZOPFAN at the 26th AMM in Singapore (1993) has resulted in a *Programme of Action for ZOPFAN*. The Programme comprises certain major elements, such as strengthening the bilateral and trilateral networks among ASEAN countries and other Southeast Asian countries; the development of a code of conduct which binds Southeast Asian countries and those contiguous to the region through the Treaty of Amity and Cooperation; to develop a politico-security blue-print to enable friendly countries to assist in the build-up of peace, stability and prosperity in Southeast Asia, and the development of a framework to achieve, sustain and build up peace in accordance with the Charter of the United Nations.

The core elements of ZOPFAN are the strategy of national and regional resilience, which consist of the various dimensions of national life: ideological, political, social, cultural, science and technology and security and defense.



National and regional resilience, for Indonesia, are the most pertinent responses towards challenges both from inside the region and beyond. National resilience ensures internal security and stability, while regional resilience ensures regional security and stability. Their purposes are to ensure the region's security from external interference as well. Hence, for Indonesia, ZOPFAN, the Treaty of Amity and Cooperation, its legal instrument, and the SEANWFZ, its military component, are the major pillars of the ASEAN and Southeast Asian security architecture. Their immediate realization is requisite in order to provide the region with indigenous security architecture "within which the legitimate interests of regional and great powers alike can be safeguarded."<sup>3</sup>

The concept of ZOPFAN, which is based on the strategy of national and regional resilience, must, therefore, be equipped with a more comprehensive security concept and strategy comprising non-conventional security issues, such as human rights, sustainable development and the protection of the environment, narcotraffic, trafficking of women and children, human smuggling, etc. It should thus incorporate human security and development. Human security encompasses a wide spectrum of people's rights, including the right to obtain information, to have good governance, to participate in democracy, and to have equal opportunity to develop. At the minimum, human security is

understood to mean the freedom from fear and freedom from want. At the highest level, it calls for political, social and economic environments that guarantee the dignity and the rights of the individual and provide the framework for unrestricted development of the individual's potentials. Thus, in enhancing human security, there has to be a fundamental attitude change on the part of governments, especially where the dominant perception is that they should play the roles as guardians of their states' sovereignty and security.

New concepts and strategies to allow their constructive involvement will enable ASEAN to shape and set the regional security agenda required to face an uncertain future and design and nurture a "conflict-free" future for Southeast and the adjacent regions in the wider Asia-Pacific region. The great powers will have to be invited to play a constructive role in the build-up of the new security architecture. Yet their contribution to the new security build-up will have to be sought on ASEAN terms.

### The ASEAN Regional Forum

A theoretical framework for security and stability in the Southeast Asia and the broader region has been devised. It retained the core elements of national and regional resilience but should be expanded to contain and deepen cooperation in the economic and social fields, as equally major se-

curity elements between ASEAN and its major dialogue partners. It contained long-range efforts to deal with intractable global problems: the building of a more effective regional or even international collective-security capability (such as a UN peace-keeping force and a strengthened international court of justice); the reduction and control of armaments; and such new issues of security and stability, as the discipline of population growth, the enhancement of human rights, the protection of the environment, the alleviation of poverty, disease and illiteracy, and the establishment of constructive trade and investment policies and their facilitation. These fundamental long-range considerations of a strong economy and a healthy society are the prerequisites for a strong regional organization in Southeast as part of the bigger Asia Pacific area and of the globe.

The forum towards such an enterprise has been made available since the 26th AMM in Singapore in 1993 in the form of the ASEAN Regional Forum. It started as an "armchair discussion" rather than a full-fledged formal meeting on security and stability issues in the wider region. It has gone beyond the stage of getting to know one another to develop confidence and trust or a certain level of comfort among the various parties. It developed into a forum for discussing the establishment of a new order in the region in this post Cold War era.

The ASEAN members of the ARF want it to develop in an evolutionary and non-legalistic manner rather than in a more structured fashion. It should move evolutionary in three stages. It should start with the promotion of confidence building, then the development of preventive diplomacy and in the end, elaboration of approaches to conflicts, although their achievements are not designed in strict time series.

The ARF process is now, so it was agreed in Brunei Darussalam on August 1, 1995, in its first phase, the phase of confidence building. The process of developing preventive diplomacy can proceed in tandem with phase one, while the elaboration of approaches to conflicts is the eventual goal of the ARF process. The decision-making process in the ARF will remain to be made through consensus after careful and extensive consultations among its 19 members.

Although the ARF has endorsed the purposes and principles of the Treaty of Amity and Cooperation as the code of conduct, ASEAN was not agreeable to apply the Treaty of Amity and Cooperation in Southeast Asia in its entirety, as an international code of conduct, even though it was amended in 1987 by two articles that allows non-Southeast Asian countries to become party to the Treaty. It was argued that allowing outside countries to become party to the Treaty would



enable them to intervene in Southeast Asian affairs in the process of the pacific settlement of disputes.

## THE NON-CONVENTIONAL SECURITY ISSUES

On November 5, 2001 ASEAN leaders in their *Joint Action to Counter Terrorism* unequivocally condemned the terrorist attacks of September 11 as an "attack against humanity and an assault on all of us." They viewed terrorism as a "direct challenge to the attainment of peace, progress and prosperity of ASEAN and the realization of ASEAN Vision 2020, "while rejecting "any attempt to link terrorism with any religion or race." ASEAN was further committed to "counter, prevent and suppress all forms of terrorist acts in accordance with the Charter of the United Nations." All joint efforts to combat terrorism at the regional level should consider "joint practical counter-terrorism measures in line with specific circumstances in the region and in each member country." The leaders also acknowledged the ASEAN regional framework for fighting transnational crime and its ASEAN Plan of Action to prevent and control transnational crime. ASEAN's leaders issued a nine point action plan ranging from strengthening national mechanisms, deepen cooperation among front-line law enforcement agencies, enhancing information/intelligence exchange, regional capacity building, all of them to combat terrorism in the region strictly under the U.N. umbrella.

A special ASEAN Ministerial Meeting on Transnational Crime (AMMTC) on terrorism, which was held in May 20-21, 2002 in Kuala Lumpur, was also a follow-up on the U.N. call to enhance coordination of national, sub-regional and international efforts as part of a global response to this serious challenge and threat to international security. The fight against terrorism in the region is integrated into the complex of the fight against transnational organized crime. The distinction between terrorism as a political crime and any other form of organized crime as an economic one is conveniently ignored.

ASEAN's Seventh Summit in Brunei Darussalam tasks the ASEAN Ministerial Meeting on Transnational Crime comprising the Ministers of Home Affairs of the member countries to continue to focus, next to transnational crime, on, "terrorism and deal effectively with the issue at all levels and endorse the convening of an Ad Hoc Experts Group Meeting and special sessions of the SOMTC and AMMTC focussing on terrorism." Non-conventional threats seem to be the ASEAN Heads of Governments a task of the AMMCT rather than that of the Foreign Ministers. However, with the introduction of terrorism in the ASEAN Regional Forum, Foreign Ministers will have to deal with that issue in that forum. It will thus be a coordination problem in fighting terrorism in ASEAN.

The ASEAN Ministers of the Interior/Home Affairs convened for the first time in Manila (18-20 December 1997) to cooperate in combating transnational organised crime, including terrorism. They decided that they would be the highest policy-making body on ASEAN cooperation in combating transnational crime (ASEAN Ministerial Meeting on Transnational Crime- AMMTC) and convene once in every two years to coordinate activities of relevant ASEAN bodies, such as the ASEAN Senior Officials on Drug Matters, ASEAN Chiefs of National Police (ASEANOPOL), ASEAN Directors-General of Customs, and ASEAN Directors-General of Immigration and Heads of Consular Division, Ministry of Foreign Affairs. They would also cooperate and coordinate on matters of transnational crime with other ASEAN bodies such as the ASEAN Senior Law Officials' Meeting and the ASEAN Attorney Generals' Meeting. They referred, however, to the 29th ASEAN Ministerial Meeting (AMM) in Jakarta in July 1996 on the need to focus attention on such issues as narcotics, economic crimes, including money laundering, environment and illegal migration which transcend borders and affect the lives of the people in the region, and the urgent need to manage such transnational issues so that they would not affect the long term viability of ASEAN and its individual member nations; to the First Informal ASEAN Summit in November 1996 in Jakarta to re-

quest the relevant ASEAN bodies to study the possibility of regional cooperation on criminal matters, including extradition; to the decision of the 30th AMM in Kuala Lumpur in July 1997 which stressed the need for sustained cooperation in addressing transnational concerns including the fight against terrorism, trafficking in people, illicit drugs and arms and piracy; and to the agreement among Heads of Government during the Second Informal Summit in December 1997 in Kuala Lumpur to take firm and stern measures to combat such crimes as drug trafficking and trafficking of women and children, as well as other transnational crime.

ASEAN's collective fight against terrorism and other transnational crime would be seriously constrained by the strong emphasis AMMTC placed on the principle that "the sovereignty, territorial integrity and domestic laws" of each member country should be "respected and upheld in undertaking the fight against terrorism" and other crimes. Terrorism and other transnational crimes never recognized national borders and territories; their reach is global. The work programme of exchange of information and development of bilateral and multilateral legal arrangements to facilitate apprehension, enhancing cooperation and coordination in law enforcement and intelligence sharing, and development of regional training programmes, strongly emanated from the sovereignty and territorial principles.



## AGREEMENT ON INFORMATION EXCHANGE AND ESTABLISHMENT OF COMMUNICATION PROCEDURES

The Indonesia, Malaysia and the Philippines Agreement on Information Exchange and Establishment of Communication Procedures (May 7, 2002) to counter terrorism and crush a militant network allegedly bent on turning all three countries into a single Islamic state went considerably further. *Kumpulan Mujahidin Malaysia* was singled out by Dr. Mahathir as the organization to overthrow his government in its effort to set up the Islamic state in the three countries. So was the *Jemaah Islamiyah* in the three countries taking the initiative.

The formalization of formal contacts in one umbrella agreement extends beyond terrorism into other areas of transnational organized crime: money laundering, smuggling, piracy, hijacking, all the way to drug trafficking, marine pollution, and arms trafficking. All these forms of crime were carefully defined in the meeting and put in the agreement. This made the measures to fight terrorism and other forms of crime in the three countries a little more advanced in comparison to the agreement of the special AMMTC. Exchange of information, strengthening national and sub-regional capabilities to manage border and security incidents, establishing mechanisms for immediate response and assistance, sharing airline pas-

senger lists, providing access to each other's computerized fingerprints databank, sharing blacklists and undertaking joint efforts in combating terrorism were the building blocks for the cooperative mechanism in this effort.

The sustained cooperation in addressing the combat against terrorism and transnational organised crime indicate that ASEAN's fight is conducted on intensive exchange of information rather than in pursuing terrorists and other criminals across national borders. The emphasis on mutual respect for the independence, sovereignty, equality, territorial integrity and national identity of all nations within and without the region will remain ASEAN's credo in regional endeavours.

However, terrorism and transnational organised crime is primarily a crime against human beings. The principle of non-interference in each other's internal affairs should hence—in the light of the globalisation process—be interpreted broadly to allow genuine dialogue and cooperation on some universal concerns. This trend requires a new way of thinking by shifting the focus of security from defense of national frontiers to that of human beings. This approach does not suggest that the defense of national sovereignty has become less important. Respect for national sovereignty and territorial integrity is vital to most Asian countries considering their historical circumstances. The defense of human se-

curity only means that national frontiers are not the absolute defense — that the international community — in line with the amendment of the UN's security concept — should take action to halt the gravest crimes against humanity. The concepts of "constructive intervention", "flexible engagement", "enhanced interaction" have been introduced in ASEAN as early as 1998 since the dividing line between domestic affairs and external of transnational issues have become less clear.

The debate still continues. ASEAN states, acting individually or collectively, should be entitled to take diplomatic, economic or other actions towards any other state within the *Community of Southeast Asia Nations*, which has violated the principle of human dignity, provided such measures are permitted under international law and do not involve the use of armed force in violation of the Charter of the United Nations.

## ENDNOTES

- 1 Singapore's Foreign Minister S. Rajaratnam at the Fifth AMM, April 1972.
- 2 The 14 guidelines are:
  1. Observance of the Charter of the United Nations, the Declaration on the Promotion of World Peace and Cooperation of the Bandung Declaration of 1955, The Bangkok Declaration of 1967 and the Kuala Lumpur Declaration of 1971;
  2. Mutual respect for the independence, sovereignty, equality, territorial integrity and national identity of all nations within and without the region;
  3. The right of every state to lead its national existence free from external interference, subversion or coercion;
  4. Non-interference in the internal affairs of zonal states;
  5. Refraining from inviting or giving consent to intervention by external powers in domestic or regional affairs of zonal states;
  6. Settlement of differences or disputes by peaceful means in accordance with the Charter of the United Nations;
  7. Renunciation of the threat, or use of force in the conduct of international relations;
  8. Refraining from the use of armed forces for any purpose in the conduct of international relations except for individual or collective self-defence in accordance with the Charter of the United Nations;
  9. Abstention from involvement in any conflict of powers outside the zone from entering into any agreement, which would be inconsistent with the objectives of the zone;
  10. The absence of foreign military bases in the territories of zonal states;
  11. Prohibition of the use, storage, passage or testing of nuclear weapons and their components within the zone;
  12. The right to trade freely with any country or international agency irrespective of differences in socio-political systems;
  13. The right to receive aid and freely for the purpose of strengthening national resilience except when the aid is subject to conditions inconsistent with the objectives of the zone;
  14. Effective regional cooperation among the zonal states.
- 3 Confidence Building Measures in Southeast Asia, *ASEAN-ISIS Memorandum* No. 5, December 1993, p. 11.



## National Stability at Stake?

*Staff, Department of Politics and Social Change, CSIS*

### INTRODUCTION

POLITICAL development from June to August 2003 signaled the downturn of Indonesia's security situation. Latest horrific bombing at J.W. Marriott hotel in Jakarta's Kuningan main business district area on 5 August 2003 is an obvious case of the rising threat to national security. Previously, small bomb explosion happened in the parliamentary building on 14 July 2003. In the war zone of Aceh, so far the military operation has been running with little progress. Meanwhile, peace in Poso, Central Sulawesi, was troubled by recent bombings and killings. Most recently, Peace in Papua has just been endangered again by "civil war" ignited by the declaration of new Provinces of *Irian Jaya Barat* (West Irian Jaya) and *Irian Jaya Tengah* (Central Irian Jaya).

Other security-related cases that make Indonesian worried were the finding of tens of kilos of bomb materials in Semarang and Jakarta and documents of killing plot to politicians and businessmen following the arrest of some alleged radical *Jamaah Islamiyah* (JI) members. However, Indonesia security forces could be little bit relieved following the arrest of an Indonesian who is the most wanted man and alleged terrorist mastermind in Asia, Hambali alias Riduan Isamuddin, in the early of second week of August in Thailand.

The dynamics of local politics, especially on the election processes of governors and regents and mayors, have disturbed the sense of public security. In some areas, like in Central Java, South Sumatra, and Bali, there were high disappointments of supporters of local leaders toward decisions made by their central parties'

functionary boards who nominated the incumbents or candidates from outside of the parties. Some run amok, burning parties' flags, buildings, and other properties. In other areas, such as happened in Buol, Central Sulawesi on 16 August 2003, masses destroyed local parliamentary building and official cars as an expression of their anger toward the performance of local legislatures.

At the national level politics seems run smoothly, although there are problems in the relationships between the executive and legislature bodies. Both bodies have different positions on some issues, especially on the purchasing of four jet fighters and two military helicopters from Rusia. The issue, which has been known as *Sukhoi-gate*, has been followed up by Commission I of the House of Representatives (DPR) covering defense, security, and foreign affairs with the establishment of a working committee (*panitia kerja/panja*).

In the period of June-August 2003, political development in Indonesia had been also marked by the 'trial-and-error' attempts from major political parties to form loose alliances in the processes of electing governors, regents, and mayors. Most of 'tactical' alliances failed to achieve the objectives, causing bitter relationships between major contestants of the next year elections. Other issues related with the political parties are the ongoing internal problems in several

major political parties, particularly in PKB (National Awakening Party) and PDI-P (Indonesian Democratic Party of Struggle), and the withdrawal of Nurcholish Madjid, a highly respected Moslem scholar, from the Golkar Party's convention to select presidential candidate because of the lack of money factor.

Within the same period there was another political event, i.e., the annual session of People's Consultative Assembly (MPR) from 1-7 August 2003, concluded two days ahead from its original schedule. This session, unfortunately, did not make any substantial progress for the improvement of Indonesian politics in the coming years, except for the decision to establish a Constitutional Commission (*Komisi Konstitusi*). Some controversial issues, such as the annulment of decrees on former President Soekarno and the banning of communism, were dropped from the discussions, making hard for the government to rehabilitate one of Indonesia's founding fathers and those who have experienced political injustice and arbitrary treatments from New Order regime.

## PATTERN OF POLITICAL DEVELOPMENT

In general, political development during June to August 2003 on the one hand reflects the escalation of security problems and, on the other hand in-



icates the downgrading of democratic quality. Security and democratic functions are in fact interlinked. In advanced democracies, security becomes the function of democratic institutions and is not merely the domain of repressive state apparatuses. The basic assumption is that if democratic institutions function effectively, there should be less unresolved or un-accommodated aspirations and demands. In this situation, security problems are usually related to the problem of tolerating minor voices and groups and external threats, but not with the bigger internal threat to national security.

However, in the case of Indonesia, it seems that the immature democracy system and institutions have caused many disappointments and resentments from public in general and marginal groups in particular, either from small but militant groups or oppressed people. Unfortunately, President Megawati, who is also the head of the biggest political party, does not seriously work to accommodate local aspirations and, instead, she rules the country and her party with 'iron-fist' type of government. In many cases, she uses her 'prerogative' rights arbitrarily, especially in dealing with her political party's problems. Moreover, she does not take part in any discussions on critical issues either. In times of crisis, like in the aftermath of devastating bombing in Jakarta, for instance, she did not try to express

her response promptly and spontaneously to that problem. She continued to keep silent and ran her administration as usual. As such, Indonesia's internal politics has been running with lack of direction and has lost its spirit of democracy.

With a low level of democratic performance, security will usually be a serious problem for transitional countries like Indonesia. As many aspirations and demands cannot be accommodated by democratic institutions, disappointment and resentment could be easily be translated into violence. Security is also vulnerable to disruption, either from the conventional or non-conventional threats, because democratic institutions cannot respond the early warning from society. During the transition period, democratic performance had been expected to be high, as political euphoria following the availability of window of opportunity to contest in the power struggle can jeopardize the unity of society and the political stability in general. In this period, politics will most likely be all about power, which can be gained from the control of government apparatuses, masses, money, or accesses to democratic institutions.

In the case of worsening security situation in Indonesia during this period, the relationship between this problem and democracy is not yet clear. Democracy in Indonesia since its installation phase in 1999 follow-

ing the acclaimed free and fair elections has not worked effectively and properly. There are many periodic polling and surveys recorded the increasing disappointment of public toward national leader and political parties, but, so far there is no causal relationship between these two variables.

However, at the local level, it can be inferred that un-democratic political decision would likely trigger violent but localized reactions. In the case of growing threat from terrorism to national security, there is no established pattern that deadly terrorist acts are used to sabotage the consolidation of democracy, as the targets are mostly soft targets like bar or hotel. The only inference that can be drawn is that democratic institutions have failed to respond effectively to the terrorist threats, as there are no substantial efforts to revise security policies and to improve the performance of security agencies with their authorities.

## SOME CURRENT SECURITY PROBLEMS

### Bombings

In this period, bombings and threat of terrorist acts, war in Aceh and tension in Poso were three major security problems. Bombings and threat of terrorist acts are related to the existence of terrorist groups, while war in Aceh is related to the military operation to quell the rebels and

tension in Poso is related to the prolonged ethno-religious conflicts. On 14 July 2004, a low explosive bomb exploded in the outside of main parliamentary building. The blast caused minor damage and no fatalities, but it gained serious attention from the public as it happened shortly after bomb explosions that took place near the United Nations building and in Jakarta international airport.

The powerful and deadly blast struck J.W. Marriott hotel in Kuningan central business district of Jakarta on 5 August 2003. The blast damaged the hotel, killed eleven people directly and wounded hundreds of victims. This tragedy automatically reminded the public of the horrific terrorist act in Bali in October last year that killed more than two hundred people. Shortly, police started its investigation in cooperation with other international counterparts. Many believed that the bombing was planned and conducted by members of a radical group *Jamaah Islamiyah* (JI), a group of hard-liners that has a vision of Pan-Islamic state in Southeast Asia. Police confirms this with the arrest of ten people linked to JI for their involvement in the Marriott bombing on 16 August 2003.

The political impact of Marriott bombing is not threatening to Megawati's administration. Although there are many criticisms from public about her performance in delivering security, politicians seem reluctant to bring this



issue as a case to correct her. Public figures are united in voice condemning that barbaric act, but there is no strong demand for Megawati to resign or to replace her security apparatuses. Megawati's position is still strong due to her willingness to cooperate with international communities in dealing with terrorism in Indonesia.

Terrorist acts in Indonesia actually could have been predicted as the investigations of Bali bombers revealed some information about the terrorist networks and plans. In the raids in Jakarta, Bekasi and Semarang in the mid of July 2003, police found documents from alleged JI members. In these documents, there is a plot to kill four PDI-P politicians namely Roy B.B. Janis, Pramono Anung, J.E. Sahetapy and Jacob Tobing and a real estate businessman, Ciputra. Besides seized documents, police also arrested several members of JI and found tens of kilos explosive materials to make bombs in Semarang. This finding confirms that terrorist network in Indonesia is still operational and well organized. Related to this problem is the escape of Fathur Rahman al-Ghozi, an Indonesian terrorist, from a maximum prison in the Philippines on the early of August 2003.

### War in Aceh

In the case of war in Aceh, little progress in quelling separatists has hampered the process of security re-

storation and law and order enforcement in the region. Although military and police have already dispatched tens of battalions of combat troops and sent heavy military weaponry systems and equipments, the military operation that started on early June 2003 is failed to meet its original plan. In the plan, it is predicted that the military operation would eliminate the 6000 well-armed GAM fighters in six months, but so far it captured only less than 1000 alleged rebels and seized around 400 guns and weapons.

During this period, the case of an American journalist being trapped in the conflict, William Nessen, has attracted wide attention. After being in the GAM stronghold for a while, he voluntarily surrendered to Indonesian military. Then, he was charged for immigration violation and sentenced three months to jail. Another dramatic story is the hostage of private television station, RCTI's journalists by GAM.

### Tension in Poso

Meanwhile, after being in a relatively peaceful situation for months, tension in Poso heightened up following the series of shootings and bombings in July 2003. The shootings and bombings were random, and so far there were no explanation of the doers. However, thank to the increasing level of awareness of the society, conflicting parties in the past were not triggered to escalate the

tension. As a result, peace and stability relatively could be managed by local security forces.

In Moluccas, situation progressively becomes more peaceful, even in the mid of governorship succession. On 16 August 2003, members of local parliaments elected former Patimura military resort commander, Brig.Gen. (Ret) Karel Albert Ralahalu and Abdullah Latuconsina as governor and deputy governor. This election did not trigger any violent in the society, and local security apparatuses were so far able to maintain peace and order.

### Civilian Conflicts in Papua

Papua once again has to suffer another peace and humanity problem when Papuan societal groups of those who support and those who are against the government policy to divide Papua Province into three new provinces are in physical conflict. The conflict was ignited by the declaration of the new Province of Irian Jaya Tengah on 24 August 2003, in Kabupaten Mimika. As reported, there have been four people killed and many others injured in the conflict.

No doubt that the source of the conflict is the Inpres (Presidential Decree) 1/2003 on the Accelerated Formation of West and Central Irian Jaya. The Inpres is derived from Law No. 45/1999 on the formation of West and Central Irian Jaya and North

Maluku provinces and of Paniai, Mimika, Puncak Jaya and Sorong regencies. For many observers and reasons, the Law is actually in contrast to the Law No. 21/2001 on Special Autonomy of Papua Province. Before the conflict, there had been immense pressures to the Government as not to fiercely push for the realization of the Law No. 45/1999. However, the Government seemed to have its own reasons to accelerate the implementation of the Law.

The government, through the statement of Coordinating Minister of Political and Security Affairs, Susilo Bambang Yudhoyono, now has bowed down to mounting public pressure to postpone indefinitely the division of Papua into three provinces, and has said the government will review several rulings on the province to be synchronized. By this decision, the situation in Papua is reverted to the status quo — that the recent inauguration of West and Central Irian Jaya provinces had been retracted. It hope that this decision does not end only in the clarification and or synchronization of the three contentious rulings on Papua, but should be followed by strategic policies and actions to establish justice and peace, and to improve social welfare in Papua.

### SUKHOI CASE: HALF-HEARTED INQUIRY

On the relationship between executive and members of parliament,



one heated issue in this period is over the purchasing of Russia's jet fighters and helicopters. During her state visit to Russia, President Megawati accompanied by Minister of Industry and Trade, Rini Suwandi, and chief of State Logistic Agency (*Bulog*), Wijdanarko Puspoyo, made a counter trade agreement with Russian government in April 2003. In the agreement, it is stated that Indonesian government will buy 2 Su-30 and 2 Su-27 jet fighters and 2 Mi-35P military helicopters at the price of US\$193 millions in total. Part of payment amounted to US\$26 millions is paid in cash to Russian's Rosoboronexport, while the rest will be bartered with around thirty basic commodities like crude palm oil, coffee, textile, chocolate, rubber, and garment products.

In the early process of commodity exchange, most Indonesians were not aware of irregularities, as government informed the negotiated prices openly and its scheme to pay. There were some minor voices about the price paid by Indonesia compared to other countries like Malaysia or India as well the indication of mark-up from the counter trade scheme. There was also speculation about the involvement of president's son-in-law and her palace business cliques in this deal. However, the issue of mark-up and nepotism did not last longer.

The issue that was brought forward by the members of parliament in the early stage of inquiry was on

the administrative procedure of purchase. It is stated in the defense law that ministry of defense is the sole authority for purchasing heavy military equipments and weaponry systems. However, in this case, government purchased heavy military weaponry systems without any direct involvement of the department of defense. After collecting some initial information, the members concluded to establish a working committee (*panitia kerja/panja*) known as *panja Sukhoi* to further inquire the irregularities of administrative procedure on the first week of July 2003.

The committee started its work by inviting some high profile figures like business tycoon and chairman of Indonesia Chamber of Commerce's Russia section, Setiawan Djody, banker from Haga Bank, Anton Sulaiman, and former coordinating minister for economy Rizal Ramli, who were indicated having knowledge or involvement in the purchase. The *panja Sukhoi* also invited commander in chief of the armed forces, chief of staff of air force, minister of defense, minister of industry and trade, and other related high ranking officials. However, up until now, the committee failed to hear the explanation from the Minister of Industry and Trade, Rini Suwandi, who was apparently out of town or in another meeting when a public hearing was being scheduled in the parliamentary building.

The failure to bring Minister Suwandi and the delay in the finalizing work indicates that the committee does not work seriously. As discussed earlier by committee members, the inquiry was scheduled to be concluded prior to annual session of PCA on 1 August 2003, so the House of Representatives could deliver the result. However, few days before its deadline, a final public hearing scheduled to hear the explanation from Minister Suwandi was postponed as the head of the committee, Ibrahim Ambong, went abroad. There was speculation that this was the result of compromise between government and members of parliament to bring this issue out from the discussion in the annual session of PCA, as it could be used to challenge President Megawati's administration and policies.

The working committee does not conclude its work until the end of August. It is expected that the committee's recommendations will not threaten Megawati's administration, as it is unlikely to be followed up with the establishment of special committee (*panitia khusus/pansus*) like happened to former President Abdurrahman Wahid on the case of Bulog-gate and Bruneigate.

## SOME PROBLEMS FACED BY POLITICAL PARTY

### Internal Conflict

During this period, political parties have experienced some serious prob-

lems related to their internal splits and failed tactical alliances. Internal splits and tensions occurred in major political parties like PDI-P and PKB. PDI-P suffered from serious splits as the result from the party decisions on the election processes of governors, regents, and mayors that ignored local aspirations. On the election of Central Java governor for example, Megawati as chairperson of PDI-P nominated the incumbent governor, Maj.Gen. (Ret) Mardiyanto and rejected the nomination of the head of local PDI-P functionaries, Mardiyono, who received strong support from most PDI-P branches and local members of parliament in Central Java. As Megawati insisted on her decision, Mardiyono was fired from his position and his supporters in the local parliament were threatened to be sanctioned by PDI-P functionaries. In the election, Mardiyono had lost and the incumbent governor was reelected for the second term. Mardiyono's lost triggered anger of his supporters who then destroyed some party buildings and properties.

PDI-P has also problem left from the election of governor and deputy governor of East Kalimantan. In the nomination process, PDI-P recommended its cadre, Imam Mundjiat as a candidate for governor. However, couple days before the election, many PDI-P faction members in the local parliament received instruction from PDI-P functionaries to elect the incumbent, Suwarna Abdul Fatah, who was nominated by the Golkar Party.



As a result, PDI-P candidate had lost and Fatah was elected for the second term. This case forced Theo Syafei, a confidant of Megawati, to write a resignation letter from the party leadership, as he was accused of doing money politics in the East Kalimantan governorship election. However, Megawati rejected his resignation and closed the case.

PDI-P also suffered from internal split at the national level, as there are several critical cadres like Arifin Panigoro, Roy B.B. Janis, Meilono Suwondo, and others who began to question Megawati's leadership and decisions. Responding critical voices, party leadership decides to reshuffle its functionaries in the MPR and DPR and to reorganize its research and development institute. Those who are critical to Megawati and PDI-P leadership actually have good intention to save the party. In their accounts, party's decisions especially on the nomination of governors, regents, and mayors have created deep resentment from party supporters. From the election of governor in Lampung, West Java, East Java, Bali, and recently South Sumatra, Megawati preferred to nominate the incumbents or figures from the outside of party. On 1 August 2003, as the response to internal criticism, Megawati made an unpopular decision by replacing Roy B.B. Janis as the head of PDI-P faction in the House of Representatives with former Golkar politician, Tjahjo Kumolo.

Meanwhile, PKB suffered from continuing internal problems. After split into two camps, one is headed by Alwi Shihab and the other is headed by Matori Abdul Djalil, PKB is in danger of another internal problem following the insistence of Abdurrahman Wahid, the patron of PKB, to fire party's secretary general, Syaifullah Yusuf. The rumor has created internal tensions, as some influential *kiais* (uleemas) rejected Wahid's idea. In the legal battle, PKB headed by Alwi Shihab won its case in Supreme Court. However, Matori won in the lawsuit against the dismissal of his leadership in the local court in South Jakarta, making law certainty is not fully assured yet. This legal battle has delayed the disbursement of government money allocated for political parties to PKB, although Shihab camp has been verified as an official political party by Minister of Justice and Human Rights.

### Failed Alliance

Another development related with the political parties is the failure of ad-hoc, tactical alliances for the governors, regents, and mayors elections. PKB was deeply disappointed with the failure of alliance with the Golkar Party to support its candidate, Abdul Kahfi, and Ridwan Hisyam, the head of local branch of the Golkar Party to be governor and deputy governor of East Java. As the biggest faction

in local parliament, PKB controls 33 seats out of 100 and the Golkar Party has 11 seats. However, in the election, Kahfi and Hisyam only got 34 seats, meaning some of those votes went to the elected governor, Imam Utomo, who was nominated by PDI-P and other smaller parties.

In South Sumatera, candidates for governor and deputy governor from the biggest faction, PDI-P, and other parties had lost with only one vote different to the elected pair, Syahril Osman and Mahyuddin. In the election, PDI-P nominated the incumbent governor, Rosihan Arsyad, although this nomination was rejected by the majority of local members of parliament from PDI-P. The elected pair was nominated by the alliance of small parties, but received also votes from several dissident PDI-P law-makers. However, in the election of governor of Bali, PDI-P succeeded in bringing the incumbent, Dewa Made Beratha, as the elected governor for the second term, although this decision has fueled deep frustrations and anger from PDI-P supporters who preferred their own cadres to be nominated for that race.

### Presidential Nomination

Related to the development in political parties, the Golkar Party in this period introduced a new tradition of selecting presidential candidates through party convention, a common practice in the Western democracy

on 10 July 2003. Through this convention, the Golkar Party opens the nomination to all figures, either directly associated or not to the party. In the early registration period, several figures like former commander in chief of the armed forces, Wiranto, noted Muslim scholar Nurcholish Madjid, chairman of the Golkar Party, Akbar Tanjung, media tycoon Surya Paloh, and businessman Aburizal Bakrie were named as potential candidates. After the registration period is over on 19 August 2003, there nineteen names on the list. Some of the candidates have also visited many local branches of the Golkar Party in order to get support from below, as the convention gives local branches majority votes in deciding candidates.

However, after being involved in several meetings and hearings with local branches of the party, Madjid decided to withdraw from the convention. He mentioned money politics as his main reason behind his decision. As reported in the press, he was asked many times by local branches' functionaries about his *visi, misi dan gizi* (vision, mission, and 'nutrient' or money). For Madjid, the question about *gizi* or, literally is how much money he has, indicated that the Golkar Party functionaries, either in national or local levels, do not have any serious commitment to eradicate corrupt practices and to build good governance, two most important points out of ten in his platform that he proposed as the



participant of the convention. The withdrawal of Madjid nomination has downgraded the Golkar Party image, as previously some believed that through the convention, this former ruling party would reform itself into a 'cleaner' and modern party.

### ANNUAL SESSION OF MPR: INSIGNIFICANT PROGRESS

The most important political event during this period is supposedly the annual session of MPR from 1-10 August 2003. Through this session, MPR as the only "People's Consultative Assembly" consisting of members of Parliament and representatives of regions and societal groups, in Indonesia could discuss and make decisions on some important issues like eradication of corruption, rehabilitation of political prisoners and their families, improvement of people's welfare, and revision of some contradicting laws and regulations.

However, this session contributed only minor progress for the improvement of Indonesian politics and welfare in general. There are four results from the meeting: Decree No. 4/2003 on the establishment of Constitutional Commission that will consist of 31 members recruited by the Assembly's working body, Decree No. 1/2003 on the status of Assembly decrees issued since 1960, Decree No. 2/2003 on the revision of Assembly's Internal Regulations, and Decree No. 5/2003 on suggestions to the President, House

of Representatives, Supreme Audit Body, and Supreme Court (*The Jakarta Post*, August 8, 2003).

In the Decree No 1/2003, MPR revoked eight decrees, like Decree No. 6/1978 on the integration of East Timor, Decree No. 2/1978 on the campaign of state ideology Pancasila known as P4, and Decree No. 5/1983 that gave Soeharto a title as the Father of Indonesian Development (*Bapak Pembangunan Indonesia*). In this decree, MPR did not revoke the decree on the banning on dissemination of communist, Marxist, and Leninist teachings, and on the annulment of Soekarno's presidency as previously proposed by the PDI-P faction.

However, MPR suggested President to rehabilitate Soekarno's name and other national heroes who were politically deprived by previous regimes as a compromise to PDI-P's demand. In the closing session speech, chairman of Assembly, Amien Rais reiterated the calls for a government and good governance as the only way to eradicate the chronic corruption at the central and local governmental levels. MPR also suggested government to increase health budget to between five to fifteen percent of national budget and to provide medical security plan to the people.

### CONCLUDING NOTES

Political development from June to August has some positive as well

as negative aspects. The good one is that democratic stability could be maintained, although democratic functions are far from their ideals. Megawati administration remains in power despite many serious problems happened in this period. This means that political coalition formed in the last two years is still effective in supporting current regime. Megawati administration is also able to deal with threat of terrorism, as it is demonstrated by progressive work of police to uncover the terrorist cells and to capture those who are linked to the Bali and Marriott bombings. In the local political dynamics, although there are many problems in the processes of election of governors, mayors, and regents, local governments continue to provide services to the people.

On the other hand, the deteriorating of security situation as reflected in the latest terrorist attack has a wider impact to development in other fields. Latest bombing has lowered international and business communities' confidence, and this could create economic recovery process more dif-

ficult. If economic performance is deeply affected by terrorism and government's response is far from public expectation, economic situation could worsen and political stability is at risk.

This period, therefore, could be the starting point of the declining of political stability in Indonesia. Indonesia is facing elections next year, and it is scheduled April 2003 for the election of legislators and June for the first round of direct presidential election. As usual, political dynamics would heighten, and with ongoing security problems, Indonesia's political stability could be fluctuated. Currently, many political forces have tried to consolidate their bases of support, and accumulate necessary political resources, especially money. In the situation where law enforcement is bad, threat to security is high, and public disappointment is widen, millions of unemployed and poor people could easily be mobilized by opposition and opponent groups of government to give pressures to the current administration.



# Improved Macroeconomic Condition

*Staff, Department of Economics, CSIS*

### ECONOMIC GROWTH: MODERATE GROWTH PATH RESUMED

**T**HE economy continues to proceed along its moderate growth path. In the second quarter of 2003, economic growth was 3.76% (y-o-y), slightly above that of the first quarter. The growth was mainly driven by consumption and investment, while exports were weakening and the slowdown in manufacturing growth continues to drag down the overall growth performance.

#### Private and Government Consumption

Private consumption growth continued to be high (Table 1). Its contribution to economic growth increased slightly from 78% in Q1 to 88% in Q2 2003. Declining inflation, increasing current consumer confidence as well as consumer expectation on future economic prospects may incre-

ase consumption further. However, the growth in consumer spending will be limited by the fact that the share of consumption expenditure in GDP is already very high. Moreover, credit for consumption purposes has declined from 35.4% in January to 30.1% in June.

Government expenditure, which contributed about 19% of GDP growth in Q2 2003, grew by 9%. However, the government's decision not to continue the IMF's assistance program, which is reflected in the latest conservative state budget, may limit the future ability of the government to be the engine of growth.

#### Investment

Investment contributed about 28% of overall economic growth of Q2, 2003. Most of investment growth happened in construction (5.2%), contributing to 78% of total investment growth. This is consistent with the

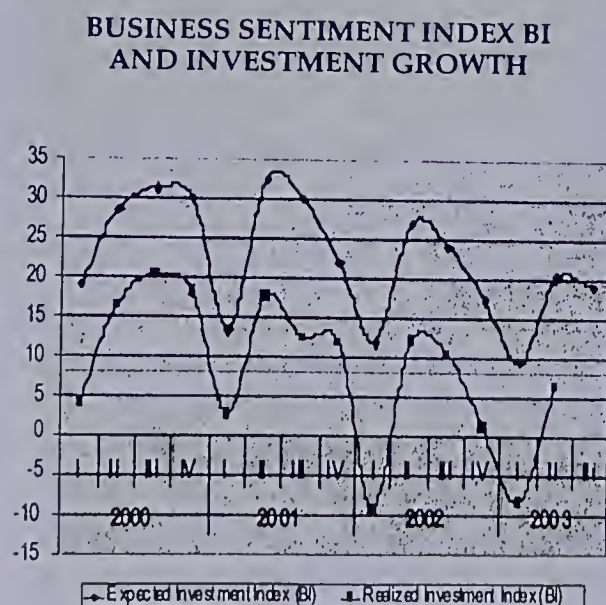
Table 1

## GDP GROWTH BY EXPENDITURE: 2002-2003

	2002					2003	
	Q1	Q2	Q3	Q4	Total	Q1	Q2
<b>GDP Growth</b>							
Private Consumption	5.6	4.9	3.9	4.5	4.7	3.9	4.7
of which food	-0.1	-0.1	0.3	2.7	0.7	2.6	4.3
of which non-food	11.9	10.3	7.8	6.2	9.0	5.1	5.0
Government Consumption	6.6	9.0	16.9	17.9	12.8	7.0	9.2
Gross Domestic Fixed Capital Formation	-8.9	-4.6	4.6	8.9	-0.2	6.9	4.9
Change in Stock	1475.7	119.9	24.8	-1.4	61.8	-9.4	33.3
Exports on Goods & Services	-4.5	-6.5	2.6	4.4	-1.2	0.7	0.2
Imports on Goods & Services	-25.7	-20.8	2.9	19.8	-8.3	9.4	-2.2
GDP	2.7	3.9	4.3	3.8	3.7	3.5	3.8
<b>% Contribution to Growth</b>							
Private Consumption	145	88	64	85	91	78	88
of which food	-1	-1	3	26	7	26	40
of which non-food	146	89	62	59	83	52	47
Government Consumption	18	18	29	39	27	15	19
Gross Domestic Fixed Capital Formation	-82	-28	24	53	-1	43	28
Change in Stock	-215	-82	-19	3	-65	16	-49
Exports on Goods & Services	-50	-52	17	31	-10	5	1
Imports on Goods & Services	285	157	-16	-112	59	-58	13
GDP	100	100	100	100	100	100	100

Source: BPS

Figure 1



Year on year growth Investment	2003	
	Q1	Q2
Construction	5.3 (57)	5.2 (78)
Machine & Appliance (Domestic)	14.6 (3)	9.1 (3)
Machine & Appliance (Foreign)	1.3 (3)	-5.1 (-14)
Transportation Equipment (Domestic)	24.4 (12)	10.5 (8)
Transportation Equipment (Foreign)	-16.5 (-11)	-23.1 (-21)
Others (Domestic)	84.2 (34)	71.2 (43)
Others (Foreign)	15.8 (2)	11.7 (2)
Total	6.9 (100)	4.6 (100)

Notes: number in the brackets, are % contribution to total investment growth.

Source: Bank Indonesia



sectoral pattern of credit growth. Most of credit growth was related to mining, trade and services — sectors which require a considerable amount of construction works.

Business sentiment (see Figure 1) and favorable macroeconomic conditions has been supportive to the investment climate. Similar to the trend of consumer confidence, realized and expected investment index increased considerably in the second quarter of 2003. Another indicator showing the resumption of investment is credit growth. Overall credit growth increased during the first half of 2003, rising from 18.6% (y-o-y) in January to 25.2% in June.

### **Production Side**

On the production side, agriculture and manufacturing performed poorly while mining, utilities and service sector grew far higher than GDP growth (Table 2). This is consistent with the detailed investment figure and sectoral pattern of credit growth mentioned previously.

Relatively weak agriculture growth was due to seasonal factors. Mining grew strongly by 4.4%. The manufacturing sector, the largest sector in the economy, performed poorly in 2003. Manufacturing grew by 2.8% slightly higher than that of Q1 2003 but much lower than overall GDP growth. The contribution of manufacturing to GDP growth sharply shrank from 55% in Q1 2002 to 20% in Q2 2003.

In contrast, all sectors in the utilities and services category grew higher than GDP. The growth rate of the construction sector stands out. Its growth rate increased from 1.9% in Q1 2001 to 5.3% and 5.2% in Q1 and Q2 2003, respectively, while its contribution in GDP growth was more than doubled from 4.2% to 8-9% during the same period. This is consistent with detailed investment figures (see Figure 1). The growth of investment in construction was around 5% in 2003 (y-o-y). Transport and communication, business services, trade, hotel, and restaurant continued to enjoy rapid growth in 2003.

### **Outlook for 2003: Four Percent at The Most**

As macroeconomic stability over the past 9 months in terms of sustained moderate growth, low inflation and low interest rate, had been achieved and the world economy has started to recover, the prospect of economic growth for the year 2003 is relatively brighter than last quarter, we revise our forecast upwards to 3.5-4.0% in 2003.

### **MONETARY DEVELOPMENT: INFLATION AND INTEREST RATE CONTINUE TO DECLINE**

#### **Inflation Continues to Fall**

Indonesia's economy is further heading towards a low-inflation environment. The consumer price index continued its downward trend in the

Table 2

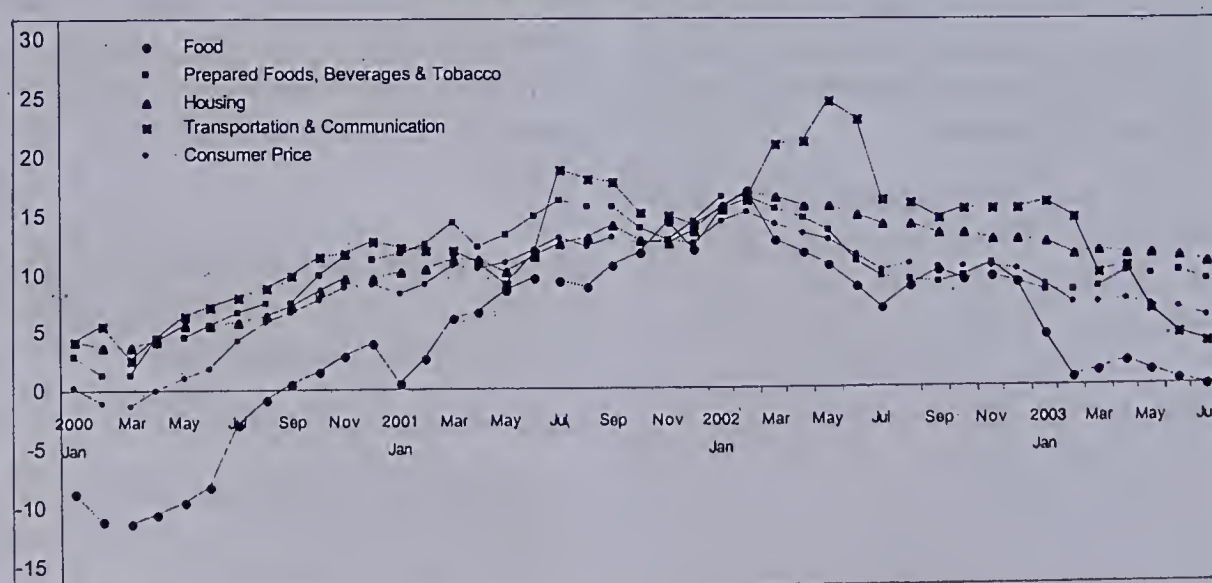
## GDP GROWTH BY SECTOR: 2002-2003

	2002					2003	
	Q1	Q2	Q3	Q4	Total	Q1	Q2
<b>GDP Growth</b>							
1. Agriculture	-3.1	3.9	3.8	2.4	1.7	4.3	1.6
2. Mining	-1.5	2.2	2.7	5.7	2.2	-0.8	4.4
3. Manufacturing	5.6	3.9	4.1	2.4	4.0	2.3	2.8
4. Electricity, Gas & Water	8.0	3.1	4.5	9.1	6.2	5.7	7.5
5. Construction	1.9	3.2	5.4	5.9	4.1	5.3	5.2
6. Trade, Hotel & Restaurant	2.7	3.3	4.7	3.7	3.6	4.3	4.6
7. Transport & Communication	8.9	8.8	7.5	6.2	7.8	6.8	7.3
8. Business Services	4.4	5.2	5.8	6.8	5.5	6.2	5.8
9. Services	2.7	1.8	1.6	1.8	2.0	2.0	2.2
GDP	2.7	3.9	4.3	3.8	3.7	3.5	3.8
<b>% Contribution Growth</b>							
1. Agriculture	-19.8	16.8	15.5	8.8	7.7	19.8	7.1
2. Mining	-5.6	5.3	5.8	14.3	5.8	-2.2	10.7
3. Manufacturing	54.6	26.8	25.8	17.5	29.1	17.5	19.5
4. Electricity, Gas & Water	4.9	1.4	1.8	4.2	2.9	2.8	3.4
5. Construction	4.2	4.9	7.3	9.3	6.6	8.9	8.1
6. Trade, Hotel & Restaurant	16.3	14.1	17.9	15.8	16.0	20.0	19.8
7. Transport & Communication	24.6	17.0	13.1	13.0	16.2	15.4	15.2
8. Business Services	11.3	9.3	9.3	12.5	10.5	12.5	10.7
9. Services	9.5	4.5	3.5	4.5	5.1	5.3	5.4
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BPS

Figure 2

## INFLATION RATE (Y-O-Y)



Source: BPS



past quarter (see Figure 2). Inflation falling from 6.9% in May to 5.7% in July. On a cumulative basis, prices only rose by 1.3% until July, thus ensuring single digit inflation by end of 2003. Food is still leading the way, declining from 1.7% in May to 0.2% in July, while housing remains the only item showing double-digits at 10.7% in July. On a monthly basis, the downward pressure on prices was even more pronounced, with food items showing continued deflation during the first six months of 2003 and further declining by -0.7% in July. Overall, the decline in prices can be attributed towards a mixture of stable rice prices —also due to imports— and general weak demand and moderate growth. In addition, exchange rate fluctuations have not played a significant role in determining domestic price increases since the peak of the economic crisis in 1998/1999.

The prospects for achieving low inflation in 2003 are good, despite expected seasonal pressures towards the end of the year. Prices are expected to rise again during the remaining months of 2003, as the government should increase gasoline prices further as part of its commitment to reduce fuel subsidies. Rice prices should also increase in the next quarter, as domestic supply of rice will fall due to late harvests after a long drought. This is evidenced by reports on shortages in several districts in Java in late August. Dry

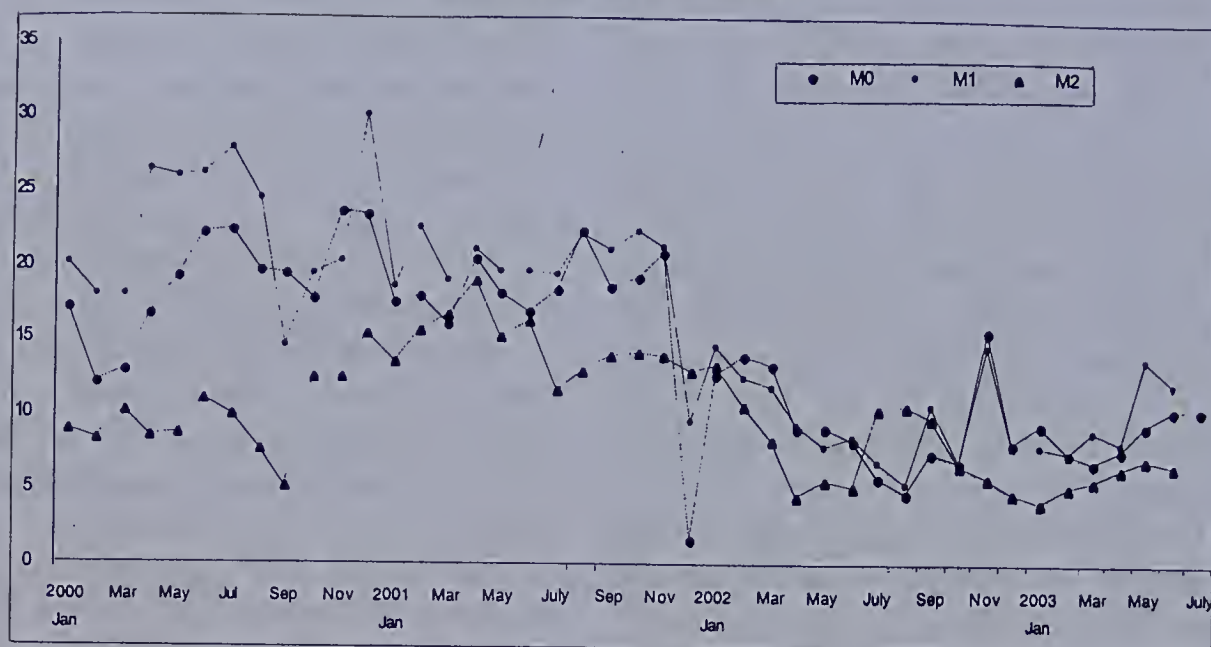
weather conditions could also result in electric power shortages, possibly affecting production and supply capacities. Lastly, seasonal pressures due to Ramadhan and Christmas festivities will also exert inflationary pressures. However, we expect the economy to experience single digit annual inflation by end of 2003, possibly even hovering around 5%. The reason is that the low cumulative inflation rate of 1.3 up until July makes room for prices increases. Barring any major shocks, the previously mentioned uncertainties should add around 3-4% inflation, at the most, during the remainder of 2003. An annual inflation rate of around 5% would be a great achievement, as the targeted inflation rate in the 2003 budget was set at 9%.

### **Monetary Fundamentals Are Sound**

As argued in previous reports, the most important factor behind inflationary pressures is the Central Bank's determination to keep money supply in check. Past data show that this was the case over the medium and longer term. As long as base money has been kept below the indicative target, inflation did not spiral out of control. Bank Indonesia has shown monetary discipline since more than a year and continues to do so. Base money stood at Rp.131.1 trillion by end of July, well below the targeted Rp.135 trillion. Thus, monetary fundamentals are sound and provide the guarantee for stable price trends.

Figure 3

## MONEY SUPPLY (Y-O-Y)



Source: BI

Demand for money has slightly increased during the past quarter, possibly signalling a positive effect of lower real interest rates on consumption behaviour. Growth of M0, including currency in circulation, has increased over the first half of 2003, peaking at 10.5% in July. Moreover, M1 and M2, which include demand and time deposits, have declined slightly in June (Figure 3). The net effect seems to be an overall increase in the demand for money.

Does this increased money demand reflect rising consumer confidence coupled with lower expected inflation or is increased money in circulation a sign of inflationary expectations? We are cautiously optimistic that the former is the case, for four reasons.

First, Bank Indonesia's continued policy to continuously lower the interest rates (see next section) for nearly a year must have by now assured consumers and investors that the economy is approaching a low-inflation environment. Second, in contrast to many other countries, inflationary expectations are not built in automatically in Indonesia's economic structure in the form of indexed wages. Third, a sizeable portion of Indonesia's economic growth can be attributed to informal economic activities. The large informal economy has been insulated from external exchange rate fluctuations, and this might also lessen the role of expected inflation as a main factor in pushing price rises. Fourth, general demand and production activities in



the smaller formal sector are still too weak to build up inflationary pressures.

Thus, expected inflation is slowly decreasing and as a result consumer confidence has been solid for some time, as evidenced by rising sales of durables such as cars, housing items and domestically produced cheap consumer items. A further decline in the real interest rate should open up the possibility for Bank Indonesia to apply growth-oriented monetary policies. Therefore, demand for cash should increase further in the next quarter.

### Interest Rates Keep Falling

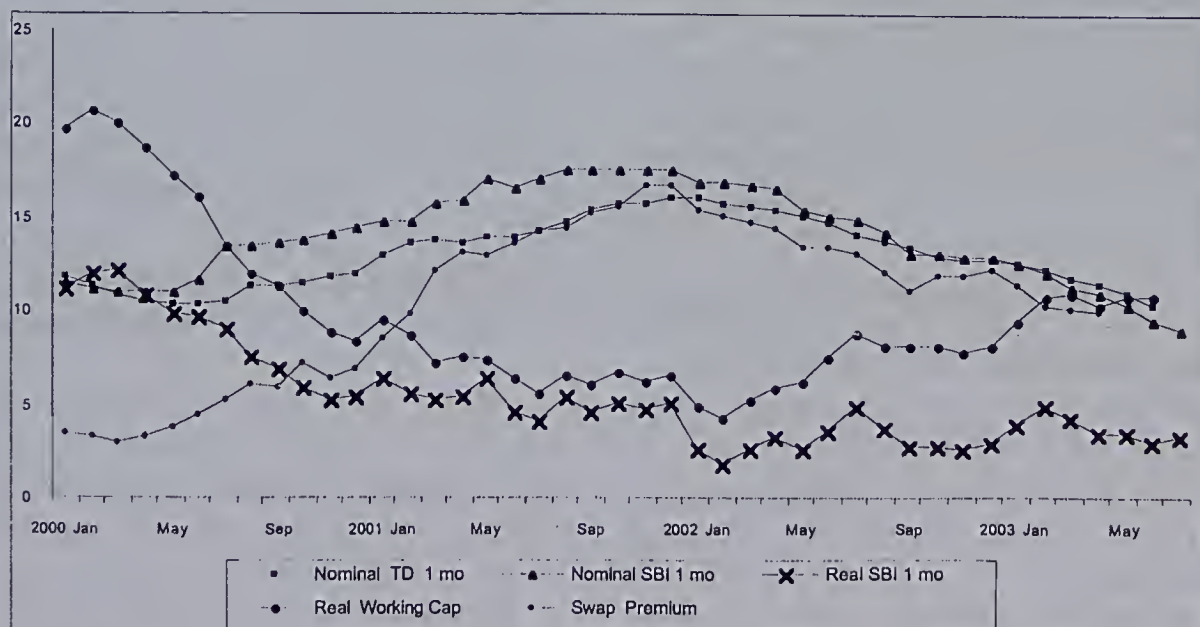
Bank Indonesia has gradually pushed for lower domestic interest rates and still has room to do so until the end

of 2003 (see Figure 4). Nominal one-month SBI rates climbed from 12.7% in January down to 9.1% in July, and finally crossed the psychologically important threshold of 9% by end of August, standing now at 8.9%. The Central Bank has preferred to approach interest rate policies cautiously by keeping the overnight intervention rate at above 12% for almost a year. However, since May BI has cut its intervention rate faster, bringing it down to 9% in July. The real interest rate is at 3.3%, still above most international rates.

Lending rates are still high for the private sector, with nominal interest rates on working capital hovering at around 17%. In addition, the guaranteed rate on deposits is also kept above

Figure 4

#### VARIOUS INTEREST RATES



Source: BI

the SBI rate. Banks are still not willing to provide cheaper loans and stay risk-averse by holding to SBI and making profits from the differential between SBI and working capital rates. In order to stimulate lending, the Central Bank should lower SBI rates quicker, and it has certainly room to do so, as base money supply is still below targets. However, currently Bank Indonesia seems to stick to higher-than-necessary SBI rates in order to keep enough firepower to meet next years' expected inflationary pressures during the elections.

### Credit Growth in Positive Territory

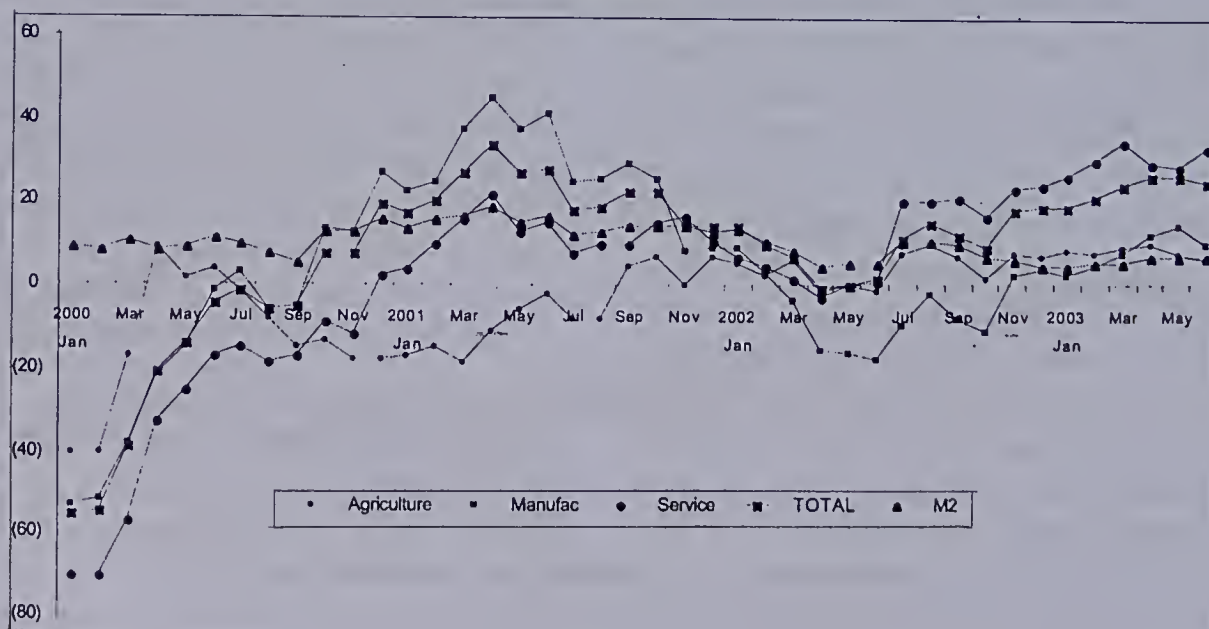
Overall credit growth increased during the first half of 2003, rising

from 18.6% (y-o-y) in January to 25.2% in June (see Figure 5). Since April all sectors recorded positive credit growth rates again. Credits allocated to mining grew spectacularly at 70.7% in June, followed by trade (40.6%) and services (32.7%). Credits for consumption purposes has declined in the first half of 2003, falling from 35.4% in January to 30.1% in June.

Banks now have started to provide more credits for investment and working capital purposes during the same period. Small business credit growth rates show a similar trend, showing negative growth for consumption credits, but increases in lending to investment and working capital purposes. However, the banking system still

Figure 5

### COMMERCIAL BANKS' OUTSTANDING CREDITS AND M2 GROWTH (Y-O-Y)



Source: BI



faces excess liquidity, with the loan-to-deposit ratio declining further from 40.8% in February to a mere 22.8% in April.

### **Bond Market Is on The Rise**

With Indonesia's exit from the IMF program by the end of the year, the government has to rely increasingly on bond issuance to finance the budget deficit. Government bonds still look attractive, as interest rates keep falling. Fixed-rate government bonds have shown a slight increase in total value traded during January-May, rising slightly from Rp.153,2 trillion to Rp.153,7 trillion respectively. Trade in variable bonds, however, declined from Rp.240,3 trillion to Rp.237,6 trillion during the same period. The corporate bond market also looks good, with the value of issued bonds rising from Rp.37.8 trillion to Rp.40 trillion during January-May. Continued macroeconomic stability with moderate to low inflation should further support the development of the secondary bond market in Indonesia.

### **A Robust Rupiah and A Flat Stock Market Price**

Financial market sentiments remained largely positive during the first half of the year, and even the Marriott bombings had only a brief impact. The Rupiah has strengthened continuously since the beginning of the year. In January, the Rupiah still

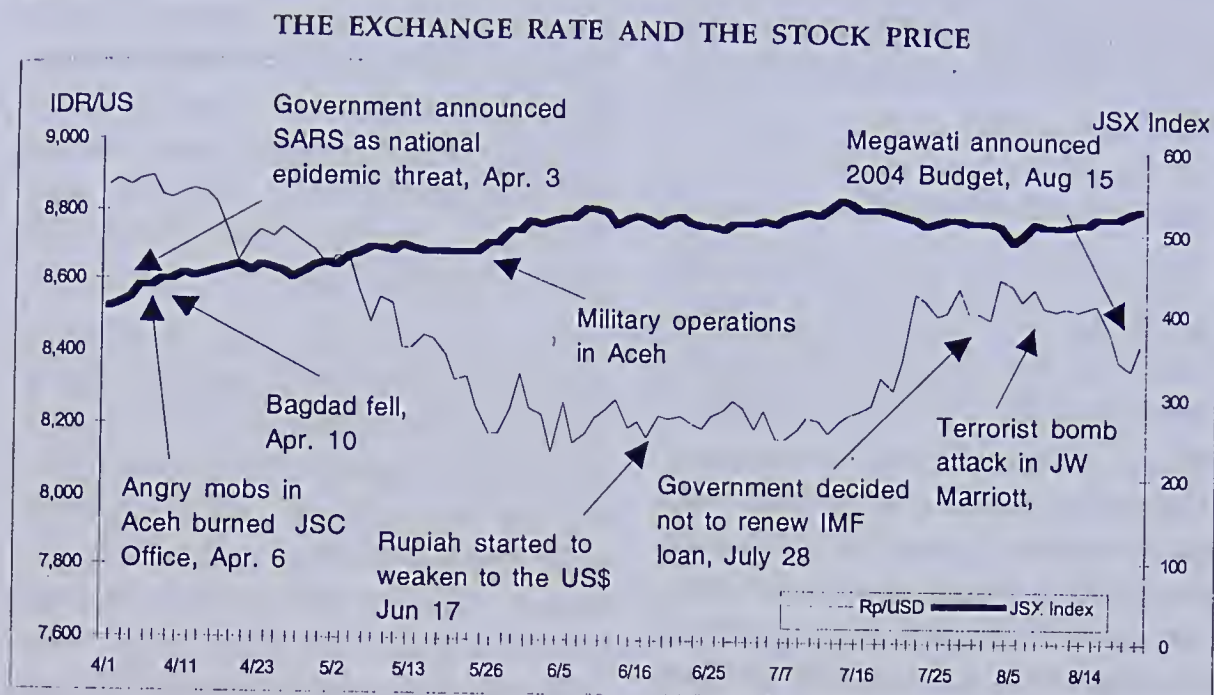
stood at around 8,900 to the US Dollar, but strengthened then to 8,200 in mid-July. Since then the domestic currency has hovered in the Rp.8,400-8,600/US Dollar range. Stock market prices remained fairly constant, with the index moving close to the 500 points level (see Figure 6).

For most of the year, the stable macroeconomic environment and a declining risk premium have led to some capital inflow, thus strengthening the Rupiah and stimulating foreign interest in the domestic bond market. However, recently the US Dollar has stopped its downward trend and consequently the Rupiah has lost some of its newly gained value. The Marriott bombing has also briefly impacted market sentiment, but the effects were mild. Overall, capital markets focus more on Indonesia's credibility to deliver on the macroeconomic and policy reform agenda. The government's budget for 2004 and its financing plan after the IMF program have received positive reactions and seem to have won over domestic security concerns.

### **Prospects: Continued Low Inflation**

Expectations on the Indonesian economy remain positive, riding on the back of sound monetary and fiscal policies. Higher-than-expected GDP growth in the second quarter, lower inflation and interest rates, higher exports of goods, sufficient foreign exchange reserves at US\$34 billion and

Figure 6



Source: BI

a realistic budget for 2004 have further improved market sentiments. Monetary fundamentals are in place, with base money still below the indicative target. Thus, Bank Indonesia has still the capacity to further lower domestic interest rates, possibly approaching the 8% level in the next quarter. The prospect for low inflation in 2003 —possibly in the order of 5%— looks good, as cumulative inflation stood only at 1.3% by mid-year. We assume a scenario, in which the Central Bank only gradually loosens money supply and positive sentiments in the financial markets will ensure moderate capital inflow during the remainder of the year. Thus, we reiterate our view that the Rupiah should stabilize at around 8,000-8,500/US\$ in the next quarter.

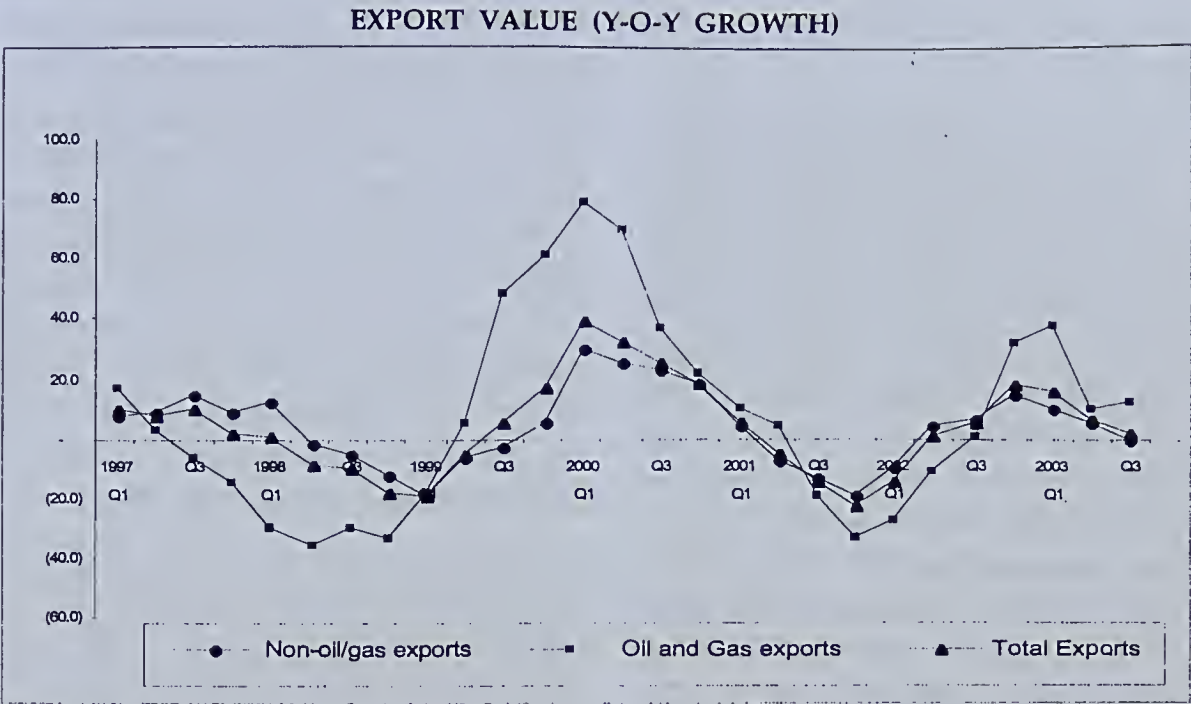
## BALANCE OF PAYMENT

### Improved Export Performance

In the first half of 2003, exports reached US\$30.4 billion, exhibiting a high growth of 10.5% (y-o-y). The first half of 2003 witnessed a consistent improvement in monthly export performance beginning March this year. Oil and gas exports, which contributed about 23% to total export, showed a 23% growth due to an increase in export volume, while the oil price declined recently. Non-oil and gas export, which contributed about 77% of total exports, grew at a much lower rate, 7.3% (y-o-y). Manufacturing exports —the biggest portion of Indonesian export (about 66%)— drove the positive performance of non-oil ex-

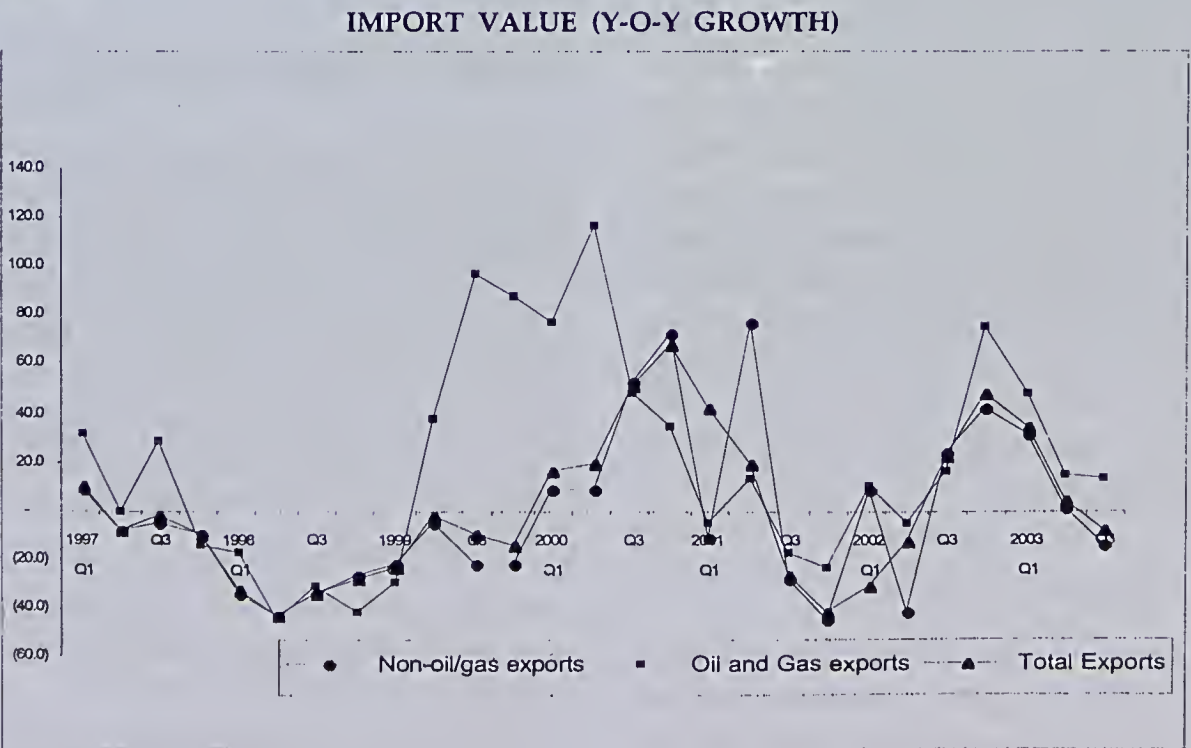


Figure 7



Source: BPS

Figure 8



Source: BPS

ports. They grew by 6%, while mining, accounting for about 7% of total export, grew at 30%.

However, traditional manufacturing export goods remained weak. Export of machine and electricity equipments, which is biggest part of Indonesian manufacture exports (12% of total non-oil exports), showed a slight decline reaching US\$2.9 billion in the first half of 2003. Other traditional manufacturing exports, such as footwear, textile and garments were even weaker. Export commodities showing positive growth in the first half of 2003 were fats and oils (HS15), ore, slag and ash (HS 26), organic chemistry (HS29) and copper (HS74).

US, Japan and Singapore continued to be the main Indonesian non oil and gas export destination, absorbing almost 40% of total non oil and gas exports. As the US and Japan began to show positive economic growth, Indonesian export in the near future would continued to improve. However, supply-side problems need to address to make the potentials be reality. These problems range from lack of working capital, high transaction cost due to legal and illegal levies to security.

### **An Increase in Imports**

Following the positive export performance, imports also increased. In the first half of 2003, imports reached US\$16.2 billion, exhibiting a

17% increase (y-o-y). The increase was mainly due to the increase in raw materials/intermediary goods and consumption goods. Raw material imports/intermediary goods, accounting for about 80% of total imports, increased by 20%. While consumption goods, contributing to about 8% of total imports, increased by 16%. Oil and gas imports<sup>1</sup>, accounting for about 22% of total imports, increased by 27%. On the other side, imports of capital goods increased slightly by 1%.

Given that export is increasing, we expected that imports would follow, fueled not only by imports of raw materials/intermediary goods and consumptions goods but also by capital goods, which would grow faster than the past five years due to business expansions.

### **CAPITAL ACCOUNT AND FDI**

In 2002, the capital account deficit of US\$2.8 billion, is much lower, when compared to an almost 9 billion deficit in 2001. The much smaller deficit was mainly due to the inflow of portfolio investments of US\$1.2 billion, while direct investment and official capital flows remain negative of US\$7 billion and 0.6 billion respectively due to debt repayments.

The first half of the 'investment year' of 2003 witnessed a sharp incre-

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<sup>1</sup>Oil and gas can be both raw materials and consumption goods.



Table 3

## CAPITAL ACCOUNT (IN US\$ MILLION)

	1997	1998	1999	2000	2001	2002*)
CAPITAL TRANSACTION	2,542	-3,875	-4,569	-6,772	-8,991	-2,818
Official Capital	2,880	9,971	5,353	3,218	-738	-548
Inflow	7,594	13,736	7,933	7,490	5,738	7,351
Debt Repayment	-4,714	-3,765	-2,580	-4,272	-6,476	-7,899
Private Capital	-338	-13,846	-9,922	-9,990	-8,253	-2,270
Direct Investment	4,677	-356	-2,745	-4,551	-5,877	-7,066
Portfolio			-1,792	-1,911	-245	1,222
Other	-2,384	-13,490	-5,385	-3,528	-2,131	3,574

Source: Bank Indonesia

ase in FDI approvals, amounted about US\$4.37 billion, which is a 44% increase compared to the same period last year. The sharp increase was not a result of approvals of new projects, but due to the increase share of foreign partners in domestic investments (change of status from domestic to foreign).

### Fiscal Issues: Budget of Consequences

The 2004 draft budget reflects the consequences of the government's decision not to continue the IMF's assistance program. The government seems to play safe in setting up macroeconomic assumptions for the draft. The government assumes that the economic growth will increase from the forecast of 4.0% in 2003 to 4.5% in 2004; the inflation rate will drop from around 9% to 7%; official interest rates will fall from around 13% to 9%; and the exchange rate is set at Rp.8,700/US\$, an appreciation from Rp. 9000/US\$ forecasted for this year.

While the economic growth of 4.5% looks quite reasonable, other macroeconomic assumptions might be too pessimistic, considering recent promising macroeconomic improvement. The assumption of 7% inflation rate is likely to be too high; although it makes 2% real interest rate (9% nominal rate minus 7% inflation) seems quite conducive for an improvement of the investment climate and the recovery of the real sector. Recent trend shows that inflation might be lower for this year and also next year. It will enable the government to target lower level of interest rates, given the improvement in banking and financial conditions.

The government is forecasting a budget deficit in 2004 of 1.2% of GDP, down from an estimated 2003 deficit of 1.8% of GDP (Table 4). The reduction in next year's budget deficit mostly comes from a cut in government expenditure, while the government expects the revenue to increase by 2.3% compared to this year budget.

Similar to 2003's budget, the government's revenues for the 2004 fiscal year are expected to come from tax revenues, which is around 80% of the revenues or an increase of 6.64% from this year proposed revenue. The government expects to raise more revenues from domestic taxes to cover the decreasing revenue from the tax on international trade and non-tax revenue, which declined by 4.3% and 12%. In order to achieve the target, tax collection will be intensified and the tax office can no longer rely on the conventional tax system. However, the government assured not to introduce new taxes nor increase the tax rate. It is expected that the office will announce several new methods in collecting tax.

From the expenditure side, the draft budget represents the consequences of the government's decision not to continue the IMF's assistance program. Total routine or current expenditure is expected to decline by about 1.5% in real terms, from the budget in 2003. Continuing decline of subsidy payment, especially in fuel, will be a major contribution to the cut of current expenditure. The reduction in routine expenditure also comes from the decreasing cost of servicing government debts to both domestic and foreign in relation to the lower market interest and exchange rate. In addition to the successful bond buyback, the decline in domestic-debt's interest payment is also partly a result of a reprofiling program, which effectively

Table 4

## THE SUMMARY OF 2003 AND 2004 DRAFT BUDGET

	2003		2004		Changes 2003-04 (%)
	Budget Rp. Billion	% to GDP	Proposed Budget (Rp. Billion)	% to GDP	
Tax Revenues	336,155.5	17.3	343,876.0	17.2	2.3
Tax Revenues	254,140.2	13.1	271,022.9	13.5	6.6
Non Tax Revenues	82,015.3	4.2	72,218.9	3.6	-11.9
Grants	---	---	634.2	0.0	---
Expenditures	370,591.8	19.1	368,799.5	18.4	-0.5
Central Government Expenditures	253,714.1	13.1	253,943.1	12.7	0.1
Current Expenditures	188,584.3	9.7	185,842.4	9.3	-1.5
Development Expenditures	65,129.8	3.4	68,100.7	3.4	4.6
Transfer to Regions	116,877.7	6.0	114,856.3	5.7	-1.7
Deficit and Net Financing	34,436.3	1.8	24,923.5	1.2	-27.6
Domestic Financing	22,450.1	1.2	39,843.7	2.0	77.5
Foreign Financing	11,968.2	0.6	-14,920.2	-0.7	-224.7

Note: See Table Appendix 1 for complete draft budget



swap highly fixed interest rate bond into variable rate.

In relation to decentralization and greater autonomy of local government, central government's development expenditure will no longer become a significant driver of the economy. It would be only 3.4% of the GDP in 2004, which increases by 4.5% from this year's development expenditure or decreases by 2.5% in real terms. The driver for growth is expected to be the balanced fund transferred to regions at more than 5.6% of GDP. In fact, the balanced fund accounts for about 30% of total government expenditure. It is interesting to note that decentralization funds will be lower than this year's transfers. Revenue sharing and special autonomy funds decline quite significantly by 5.3% and 31% due to the fall of oil production. With the increasing portion of transfer taking the form of specific purpose funds, it is expected that the intergovernmental transfer will not only serve to cover local government deficits in their routine expenditure, but also provide the basis for stronger local public development and private investment.

To finance the deficit of Rp.25 trillion or 1.2% of the GDP, the government plans to obtain domestic financing of Rp.40 trillion. While the government expects revenues from privatization (Rp.5 trillion) and asset selling (Rp.5 trillion), most of the financing will come from issuing bonds and using funds from government reserves.

Although the targeted revenue from asset sales and privatization (Rp.10 trillion) is much lower than what was the target of this year (Rp.26 trillion), it is unlikely the government can meet the target easily. Asset sales may no longer give significant contributions, considering that IBRA will end its job next year and left very little valuable asset to put up for further sale. In other words, the government needs to be more aggressive in conducting the privatization program, although it is likely that the sentiment toward privatization will be very negative as the election comes closer.

As a consequence of not having a chance to reschedule foreign debt that is due next year, the government has to withdraw funds from reserve accounts in Bank Indonesia to cover scheduled debt payment and deficit. The government expects to issue Rp.28 trillion of new bonds to pay the amortization of domestic debt and buy back outstanding bonds. Yet the government needs to get more money of Rp.26.5 trillion from its reserve account. Foreign financing, which usually become the last resort to deal with budget deficit, turns to be a burden in the next year's budget as the net of the financing—new loan minus debt payment—become negative without a rescheduling program from the Paris Club.

In general, although the draft of the 2004 budget is still expansionary, there will be only very little fiscal stimulus

for the economy. With a deficit of less than 1.2% of the GDP and the monetary effect —estimated by calculating the difference between domestic government spending and tax generated from the domestic economy— of only Rp.34.7 trillion, compared to Rp.54.1 trillion this year, this draft represents a very tight budget. While it indicates a positive attitude towards fiscal sustainability, more private sector contribution to the economy must be encouraged.

## OTHER ISSUES

### Life After the IMF: A Shaky Start?

The government decided to end the IMF economic assistance program, and enter the Post-Program Monitoring (PPM) starting next year. However, the government made a shaky start for the post-IMF period after it failed to meet its first commitment, publishing a "white paper" outlining the economic reform agenda on time. This strategy paper, intended to replace the Letters of Intents (LoI) previously drawn up with IMF assistance, was supposed to be published together with the presidential speech in front of the parliament on 15 August 2003.

A circulated draft of the white paper revealed that the economic program will consist of three areas: (1) macroeconomic stabilization; (2) financial sector reform and restructuring; and, (3) promotion of exports and investment and employment creation. However, the government's strategy

lacks in details and does not set clear priorities.

The government decided to end the IMF economic assistance program and enter the Post-Program Monitoring (PPM) starting next year. This decision, taken in July, ended the lengthy debate on the continuing presence of the Fund in Indonesia. The decision to enter PPM was well received by the various stakeholders, including the IMF itself.

By entering the PPM, the government would be able to spread the repayment of US\$9.2 billion it owed to the Fund until 2010. Opting out of the program altogether will mean that the government will immediately have to pay US\$6.4 billion. The government's debt to the IMF would be reduced to the country's quota level, US\$2.8 billion, and will significantly reduce the foreign reserves, currently standing at around US\$24 billion.

Under the PPM scheme, an IMF team would visit the country twice a year to provide unbinding assessments on the government's economic policy. Although unbinding, IMF could publish its assessments, and thus influence market sentiments.<sup>2</sup>

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<sup>2</sup>Under the current scheme, the government's economic policy is outlined in the Letter of Intents (LoI). The LoI is drafted periodically in a quarterly basis (four times a year), and must be approved by the IMF Board of Directors, based in Washington, D.C., before the Fund's loan being disbursed.



Ending the IMF program also means that the government is no longer eligible for the rescheduling facilities from the Paris Club creditor nations, increasing the pressure on the budget and balance of payments in the coming years. This consequence is reflected in the 2004 state budget draft.

In general, the government put too many things into the white paper, but sets no clear priorities, with many policies being either too general or too brief. One example is the policy on handling investment and export affairs. The white paper only mentions the plan to establish a national team for investment and export promotion. This team will only be formed in September, which may be operational next year, without any clarity regarding its working method to achieve its goals, according to a quoted source. Uncertainty also prevails in statements on the negative list (*Daftar Negatif Investasi* - DNI). It contains the plan to revise DNI, but it is not clear whether the list will be subject to trimming or expansion. Consequently, investors have no idea if Indonesia is heading towards economic liberalization or another intensive wave of regulation.

The credibility of the program also rests on a clear monitoring process. There are few possibilities, which can be explored. First, the government could initiate an independent monitoring body together with the stakeholders (civil society, private sector

etc.). Second, the stakeholders could also initiate their own monitoring mechanism, although it would be difficult to have effective monitoring without government cooperation and readiness to supply information. Finally, whatever the modus of national monitoring is chosen, the possibility of supplementing it by making the outcomes of the IMF reviews public—conducted part of regular PPM consultations—should also be considered.

### IBRA Asset Sales

The Indonesian Banking Restructuring Agency (IBRA) failed to find buyers for loan and fixed assets worth Rp.40 trillion (about US\$4.9 billion) in July, due to low prices offered by bidders. Failure to secure buyers was a huge loss for IBRA, who targeted collecting Rp.18 trillion in cash and Rp.8 trillion in bonds this year from asset sales program this year to help finance the state budget deficit. To avoid similar problems in the future, IBRA would assign a longer period for the due diligence process, up to 45 days, during the next sale program.

### IBRA Debt Settlements

In early July, IBRA granted a 3-month extension of the Deeds of Indebtedness (*Akta Pengakuan Utang* - APU) agreement for 18 former bank owners after they failed to duly pay their debts by the June 30 deadline.

The former bankers are among 35 owners of liquidated banks, who in 1998 opted for settlements to avoid prosecution after they allegedly misused Rp.138 trillion in liquidity assistance provided to the banks to bolster their liquidity during the height of the 1997 economic crisis. Other repayment schemes besides APU are the Master of Acquisition and Settlement Agreements (MSAA) and Master of Refinancing and Notes Issuance Agreements (MRNIA).

The APU scheme covers debts worth Rp18 trillion (US\$1.96 billion). Under this scheme, the bank owners surrendered their assets to IBRA, and agreed to pay the difference if the surrendered cash and assets are insufficient to repay their full debts. Three major debtors under the APU scheme, Hendra Liem (Bank Budi International), The Nin King (Bank Danahutama) and former president Soeharto's eldest daughter Siti Har-

diyanti Rukmana (Bank Yama) had settled their debts by the June 30 deadline. The other APU debtors, among them Hasjim Djojohadikusumo (Bank Papan Sejahtera) and Nirwan Bakrie (Bank Nusa), were granted extension until September 30. If by the September deadline the bank owners fail to settle their debts, IBRA would bring their cases to the court.

But IBRA has had bad experience in bringing such cases to the court, as in their previous cases against large, uncooperative debtors under MSAA and MRNIA schemes. Poor and bad legal system of the country had instead paved the way for the debtors to escape from their obligations, costing IBRA and the country loss of state funds repayment. It appears that IBRA preferred to settle the current cases off the court, even if it means a delay or smaller amount of repayments, rather than losing everything in the legal process.



# ASEAN Economic Community: Ideas, Significance and Feasibility

Hadi Soesastro

## INTRODUCTION

THE idea on the formation of an ASEAN Economic Community (AEC) by 2020 has been included in ASEAN's agenda since it was proposed by PM Goh Chok Tong at the ASEAN Summit in 2002. Since then a number of ideas on deepening ASEAN economic integration have been developed. These include the concept paper on the *ASEAN Economic Community* prepared by the Institute of Southeast Asian Studies (ISEAS), and the ASEAN-ISISASEAN-ISIS (Track Two) Report to ASEAN Policy Makers, *Towards an ASEAN Economic Community*. In addition, the *ASEAN Competitiveness Study* by McKinsey and Company, which was commissioned by the ASEAN Economic Ministers (AEM), also proposed a modality for ASEAN to move towards a single regional market.

A High Level Task Force (HLTF) has been created by the AEM to develop a set of recommendations on

deepening ASEAN economic integration. The HLTF is expected to produce its recommendation for the ASEAN Summit in October 2003 in Indonesia. There is no shortage of ideas from which the HLTF can draw on. The big question is whether there is political will on the part of ASEAN leaders to commit themselves towards the creation of an AEC by 2020.

The significance for ASEAN to moving towards deeper economic integration is without doubt. ASEAN members have realized that they have a much greater chance to maintain their international competitiveness if they work together towards the creation of an integrated market. This led to the historic decision in 1992 to form the ASEAN Free Trade Area (AFTA). A decade later, with the AFTA project already implemented in the older ASEAN members, it has become all the more important for the group to deepen and accelerate regional economic integration. ASEAN's position in the regional and global stage had been adversely affected by

internal and external developments during the past few years. The challenge faced by ASEAN is not simply to restore its position or to catch up with the rapid progress in the region and the world. It needs to stay ahead of the curve. Deepening and accelerating regional economic integration will significantly elevate ASEAN's attractiveness as a global production base.

Economic integration will also contribute to regional cohesion. This will strengthen ASEAN's bargaining power and geopolitical influence. Deeper economic integration has been a key element in the grouping's growing trade and economic ties with extra-regional countries. These ties will be further strengthened by the development of closer economic partnerships, including free trade agreements, between ASEAN and a number of its trade partners. The ASEAN-China Comprehensive Economic Cooperation Framework Agreement is the first such initiative that will be followed by similar ones with Japan and other countries or group of countries. In East Asia, ASEAN may even be placed in the position of becoming a "hub". This is a very strategic and potentially powerful position. It will gain this position perhaps by default as none of the other East Asian economies can gain such a leadership position. The study by the ASEAN Secretariat, *Towards a Single Economic Space*, made the point that ASEAN's closer economic partnerships and free trade arrangements with key trade partners are ex-

pected to accelerate ASEAN's own economic integration towards a single economic space in the global economy.

The creation of an AEC is a feasible proposition. The AEC should be seen as a logical extension of the various initiatives taken and implemented by ASEAN thus far towards greater economic integration. It is the next logical step for ASEAN to take. However, this next step requires strong and firm commitments by ASEAN members to move forward in a credible and timely manner. This can be aided by a clear articulation of the ultimate form of integration as well as the appropriate path to achieving it. Equally important is a commitment by ASEAN members to embark on greater institutional integration.

## MAIN ELEMENTS OF THE AEC

The following discussion on the AEC idea is based on the Report of an ASEAN-ISIS discussion, *Towards an ASEAN Economic Community*, published in April 2003 (further referred to as the ASEAN-ISIS Report). The Report began with a discussion of the ultimate form of integration. It then examined the path towards deeper integration and the institutional design to successfully undertaking the AEC project, taking into consideration the political factors likely to be at play.

The Report noted that in a sense ASEAN members have already com-



mitted themselves to deeper economic integration. The ASEAN Vision 2020, adopted by ASEAN leaders in 1997, envisaged the creation of "a stable, prosperous and highly competitive ASEAN Economic Region in which there is a free flow of goods, services and investment, [and] a freer flow of capital ....."

The ultimate form of integration as proposed in the ASEAN-ISIS Report is the creation of a fully integrated market (a Common Market) in 2020 but takes into account areas where members reserve deeper integration for a later stage (beyond 2020). It suggests that ASEAN adopts a "Common Market minus" approach. An alternative approach is to adopt the "FTA plus" arrangement, namely an FTA that includes some elements of a Common Market. The former approach can be more liberalizing. Its additional advantage is in the explicit formulation of some kind of a "negative list" that can be brought under the umbrella of the integration project.

A Common Market is understood to be an arrangement in which there are complete free flows of trade, including internal trade — as in a Customs Union, as well as free mobility of labor and capital. Full mobility of labor involves the right to reside and accept employment in all member countries, and mutual recognition of professional and technical qualifications. Full capital mobility requires reduced exchange

controls, and full rights of establishment for firms in all countries.

It has been suggested that credible removal of tariffs may require policy harmonization or common policies on taxes, wages, prices, etc. It may even require common rules governing competition and monopoly, as well as in environmental regulations. However, it is still a matter of controversy whether a full Common Market requires a single currency and a common system of prudential regulations of banks and other financial institutions.

ASEAN has no problems in achieving completely free flows of trade and investment in 2020. Under the AFTA program the region will achieve completely free flows of goods by 2020 already. The older ASEAN members (ASEAN-6) have adopted a target of zero-tariff AFTA by 2010. The newer ASEAN members have also adopted zero-tariff AFTA, initially by 2018, but subsequently they have advanced the deadline to 2015 for most products. Under the ASEAN Investment Area (AIA) agreement, by 2020 there will already be free flow of investments, not only amongst ASEAN members but globally.

In fact, by 2020 most intra-ASEAN liberalization in trade and investment will be multilateralized. ASEAN members of APEC may have introduced zero MFN (most favored nations) tariffs by 2020. Other ASEAN members may have already brought down

many of their MFN tariffs to zero. In view of this, ASEAN has the potential to embark of a program to harmonize its external tariffs. This can be undertaken through progressive reduction of MFN tariffs by subsets of ASEAN members, especially those with higher tariffs. In the context of the WTO round, ASEAN members can develop common strategies to reduce their MFN tariffs. These efforts help accelerate the free flow of internal trade (as in a Customs Union) and will significantly reduce transaction costs due to the progressive elimination of rules of origin (RoO) requirements.

The liberalization of trade in services in ASEAN is pursued under the ASEAN Framework Agreement on Services (AFAS). The intention is to move more progressively than under the GATS (General Agreements on Trade in Services) of the WTO. Hence GATS Plus. This has yet to be demonstrated by the ASEAN members.

In the area of services liberalization ASEAN members need to examine two questions of policy importance. First, ASEAN should give serious attention on the sequencing of its services liberalization, giving priority to cooperation in strengthening the regulatory environment and institutional capacity. Second, ASEAN should seriously examine whether in the liberalization of services is more beneficial for ASEAN to adopt a policy of global opening.

The ASEAN Vision 2020 proposes to accelerate the free flow of professional services. In the meeting of ASEAN Ministers of Labor (or Manpower) held in Indonesia last May, some ASEAN members have raised the possibility of a free flow of labor in the region. It should be noted that significant flows of unskilled labor are already happening in the region. Regularized flows can be a means to creating a progressively liberal environment in this area. A common policy approach to regularize these flows should be brought under the umbrella of the integration project. The agreement reached at that meeting was to give priority to the free flow of skilled professionals. ASEAN members agreed to begin to develop standards of quality for professionals. Rather than developing a common standard, it seems that ASEAN members will develop national standards and later adopt some kind of a mutual recognition agreement (MRA). The free flow of professionals and skilled labor is an important element of investment liberalization in the region. The ISEAS Study recommends the removal of work permits for ASEAN skilled and creative workers that are employed in an ASEAN country outside their home country. The McKinsey Study proposed the introduction of special visas for skilled labor to ensure a balance between demand and supply.

Free mobility of capital in ASEAN is another important element of in-



vestment liberalization in the region. Financial sector liberalization in the region should be focused on its appropriate sequencing. Accordingly, in this area as well priority should be given to strengthening the regulatory environment and institutional capacity. With a few exceptions the region already has liberal exchange regimes. Concerns over the volatility of short-term capital flows are legitimate and can be addressed also through the development of a common policy approach.

In determining the appropriate path towards deeper integration it is important to assess the region's "initial conditions" for integration. In the case of ASEAN it is obvious that simultaneous trade and investment liberalization should be its main vehicle for integration. ASEAN has appropriately embarked on trade and investment liberalization through AFTA and AIA. In view of the gaps that exist among ASEAN members, particularly between ASEAN-6 and the newer members, it appears that intra-regional investments can play an important role in building regional cohesion. Therefore, the AIA needs to move more progressively. ASEAN should also take measures to seriously eliminate all non-tariff barriers (NTBs).

Fast tracking of trade and investment liberalization in specific sectors or areas may help build capacity and constituency for further liberalization. The main recommendation of the Mc-

Kinsey Study is the fast-tracking of liberalization of selected sectors, namely consumer goods and electronics, and possibly adding on other high-potential sectors, such as tourism, agrobiotechnology, and automotive industry at a later stage.

It needs to be noted, however, that ASEAN's economic integration project, which is driven by a deepening and acceleration of trade and investment liberalization, might have to introduce safeguard (or recourse) mechanisms that are based on clear principles. It is important to ensure that such safeguard mechanisms do not become obstacles to longer-term liberalization efforts.

Attempts must be made to achieve some overall balance of gains for members. This is the first principle. Experience elsewhere has shown that trade-offs can be made between net economic costs and political benefits for members. If this cannot be achieved, some flexibility can be adopted. This principle is known as ASEAN minus X (or 10-X). Perhaps it is more appropriate to formalize a two-speed ASEAN, which can involve different subsets of ASEAN members for different areas of cooperation. As the consensus-based approach becomes more difficult to utilize in ASEAN there have been proposals to introduce "qualified majority voting" for technical policy matters (the McKinsey Study) or even "coalitions of the willing".

ASEAN should also consider introducing the principle of redistribution of income or resources, which can be formalized in the form of either compensation schemes or joint efforts to provide regional public goods that would be mostly beneficial to the less developed members of ASEAN. This would help ensure the political feasibility of the integration project. In addition, there may be a need to exclude, temporarily or even permanently, some sensitive sectors from the liberalization objective. However, ASEAN members must come to an agreement to bring these sectors under the umbrella of the integration project through a common policy approach. Such common policies can focus on managing production and trade. The use of domestic policy instruments (e.g. subsidies) as a substitute for trade policy should also come under some common discipline.

Another important element of the integration project is the adoption of a common external trade policy. ASEAN as a group and individual ASEAN countries have embarked on a series of preferential, discriminatory free trade agreements (FTAs). ASEAN needs to develop a common framework so as to ensure that each of these initiatives can become a building block (and not a stumbling block) for wider regional agreements. It also should ensure that ASEAN as a group can drive the process. Otherwise, ASEAN will become a spoke to arrangements that are

determined by the trade partner. This will make it difficult to later amalgamate the different initiatives towards a wider regional arrangement. It should also be noted that uncoordinated proliferation can lead to increased tensions between ASEAN members. Some ASEAN countries that are not in the position to participate in the game of forming FTAs may be left out.

It is important to keep in mind that the production networks in ASEAN have become more complex. A common framework helps ensure that business transaction costs are minimized. Rules of Origin (RoO) that are restrictive constrain sourcing of inputs. RoO that vary across products and agreements add to the complexity and costs. ASEAN members should also promote the concept of an ASEAN cumulative RoO.

Singapore has entered into different bilateral agreements with different RoO. This may not matter for Singapore because it has no sectors (textile, automobiles) where restrictive RoO applies. In the area of electronics (IT) its bilateral agreement with the US has introduced a new rule, the so-called Integrated Sourcing Initiative (ISI), which is potentially beneficial for the region. In fact, a common policy approach can help define the role for the first mover(s), such as Singapore to strategically engage major partners in the Southeast Asian region as a whole.



The common policy framework for ASEAN may also involve harmonization of external tariffs. Subsets of ASEAN can do this by forming separate Customs Unions that will help accelerate the reduction of MFN tariffs.

Finally, a critical element of the integration project is the establishment of a credible dispute settlement mechanism (DSM). With the adoption of the Protocol on Dispute Settlement Mechanism in 1996, ASEAN has begun to move to more formalized dispute settlement mechanisms. However, dispute settlement within ASEAN should be taken out off the political realm (involving ministers or senior officials) and be brought into the legal realm. The ISEAS Study recommends the establishment of a high-level judicial body to enforce the DSM. This proposed court should be staffed by judges from every ASEAN member country. In the McKinsey Study a Dispute Settlement Bureau is to be established within the ASEAN Secretariat to process claims and to manage a roster of panelists. Ruling of disputes would be made by independent panelists who are nominated by ASEAN member countries. The study also recommends that private firms be given access to the DSM for limited types of dispute. Under the existing 1996 DSM Protocol, only member governments can bring a dispute before the DSM.

In addressing the important issue of institutional design, the ASEAN-

ISIS Report believes that for ASEAN to be able to move ahead it must be transformed from being an inter-governmental cooperation structure into a regional institution. This process can only be gradual. The Report proposed the "strategic introduction" of "regional units" into the existing structure.

The creation of "regional units" is a first step towards institutional integration. Regional units are staffed by nationals who are formally independent of governments. The regional units should initially be given charge of areas where common policy approaches have been adopted. This would include, for instance, the management of development collaboration (e.g. implementing the IAI — Initiative for ASEAN Integration) and the monitoring of progress of various other initiatives.

A stronger ASEAN Secretariat can function as the driver and guardian of the integration objective. Existing units should gradually be transformed into regional units. The ASEAN Secretariat could eventually be transformed into an ASEAN Commission. National level political oversight continues to be provided by the AMM (ASEAN Ministerial Meeting) aided by the SOM (Senior Officials Meeting) and the AEM (ASEAN Economic Ministers Meeting) aided by the SEOM (Senior Economic Officials Meeting) or eventually an ASEAN Council of Ministers.

## CONCLUSION

It is possible for ASEAN to move towards an Economic Community that is defined as a "Common Market minus". One main element of this idea is to bring the areas or sectors that are excluded from liberalization under the umbrella of the integration project and be managed through a common policy approach by newly created "regional units". These should be carefully crafted and be based on clear principles. The safeguard mechanisms should not become obstacles to longer-term liberalization and integration.

Indonesia as host of the ASEAN Summit in 2003 must provide leadership in developing these new concepts and mobilizing political support for moving towards an ASEAN Economic Community. The ASEAN Economic Community project, pursued in tandem with serious efforts to create an ASEAN Security Community, will transform the region into a zone of

peace and prosperity, a force of stability in the wider region, and a constructive player in the global stage.

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# The Impact of ASEAN-China FTA on ASEAN Economies

*Mohamed Aslam*

## INTRODUCTION

THE financial crisis that engulfed Southeast and East Asia (SEA) —which includes Indonesia, Malaysia, Thailand, and South Korea— from July 1997 onwards had served as a catalyst for deep integration among ASEAN members and had also rekindled economic co-operation between ASEAN and North-east countries (People's Republic of China, South Korea, and Japan). The enthusiasm to establish economic co-operation in East Asian (EA) region emerged at the ASEAN summit in Kuala Lumpur 1997, and again at the ASEAN summit in Manila 1999 whereby members of ASEAN, China, Japan and South Korea had reached a joint statement to form a free trade area by the year 2020. In November 2002 at the ministerial meeting, ASEAN and China signed an agreement to form a free trade area (FTA) by the year 2010. The ASEAN-China FTA is the first phase of the East Asian FTA. It

was anticipated that both parties would gain from FTA. However, the rapid growth of China since the early 1990s<sup>1</sup> is now seen as a threat to ASEAN's economic growth.

Prior to November 2002, ASEAN had experienced trade and investment diversion. China's relatively lowest cost of production as compared to ASEAN members has decreased the export competitiveness of ASEAN. The strong competition between the regions has substantially attributed to the factor of homogeneity in production

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<sup>1</sup>China is less affected by the economic crisis of 1997. In general, China acts as a "stabilizer" in the region. In this context, a stabilizer is referring to (1) the rapid growth of China absorbing over-production in crisis affected countries (Malaysia, Indonesia, Thailand and South Korea, hereafter SEA), and (2) Chinese policy on the exchange rate, that is not to devalue yuan. Both items have assisted SEA countries to overcome the severe impact of the economic crisis to them. Japan could not be regarded as a "stabiliser" since her economy was in distress since the early 1990s, thereby she is incapable to assist those affected countries accept by extending soft loan.

and exports. Those countries which have the lowest cost of production will gain in trading. On the other hand, investment diversion happens in two forms: (1) new investments or foreign firms prefer China rather than ASEAN; and (2) re-location of foreign firms from ASEAN countries to China (Singapore and Malaysia has experienced this matter). The diversion in trade and investment explicitly affect terms-of-trade, which eventually will contract income from exports. It seems that this is what ASEAN countries are experiencing lately. The ASEAN-China FTA does not promise a total gain to members of ASEAN. ASEAN members may face a more negative economic impact of the FTA than China.

### THE ROAD TO ASEAN+3

In December 1990 Prime Minister Mahathir of Malaysia had proposed the formation of the East Asia Economic Group (hereafter, EAEG-1990). EAEG-1990 is not an economic bloc. It is an economic forum or discussion mainly to focus on economic relations in the region. EAEG-1990 includes ASEAN members, China, South Korea, Taiwan, Japan and Vietnam. First, the idea of EAEG-1990 is basically to coordinate the East Asian position in the wavering Uruguay Round of multilateral trade negotiations.<sup>2</sup> Second,

the group had suggested to be a retaliatory to the formation of North-America Free Trade Area (NAFTA — composed of US, Canada, and Mexico) and European Union (EU). However, since this idea of grouping excluded United States, as well as Australia and New Zealand, hence these countries, particularly USA strongly opposed the idea.<sup>3</sup> Japan was not "keen" to get involved or participated in EAEG-1990 either. Japan's move was unexpected to those who supported the idea of EAEG-1990. Without Japan's participation, the EAEG would not be materialized since Japan was the main contributor of capital formation and export growth in the East Asian (EA) region. Japan was reluctant to involve in EAEG-1990 mainly because it had a conflict with US in trade relations.

In the early 1990s, disputes in bilateral trade between the two nations reached a critical level. Disputes largely related to the Japanese protectionist practices mainly in the sectors of automobile, filming, and services. Due to the threat of punitive trade barriers that would be imposed by the US government, it had resulted Japan saying "no" to EAEG-1990. The objection of the USA may also due to not "allowing" Japan to lead the East Asia

<sup>2</sup>Agreement on Uruguay Round negotiation was reached in December 1993 and signed in April 1994 at Marrakesh.

<sup>3</sup>US opposed the formation of EAEG on two grounds. First, it afraid that the EAEG-1990 would turn into a trade bloc. Second, the US does not wish that the group be led by Japan while she is being neglected.



regions. This is also the main reason why the proposal to form Asia Monetary Fund (AMF) by the Japanese government was immediately shot down by the USA in 1997.<sup>4</sup> Since there was an intense objection from USA and little support from members of ASEAN, the establishment of EAEG-1990 was unsuccessful.<sup>5</sup>

At the ASEAN finance minister summit in 1991, in principal ASEAN agreed to accept the idea of EAEG but in a different form, i.e., the group was only means for discussion on economic matters rather than a trading bloc. ASEAN realized that it needed to have solid cooperation with major EA countries in economic relations. This is a possible reason for the formation of East Asian Economic Caucus (EAEC) at the ASEAN summit in 1992.<sup>6</sup> The EAEC meeting involved ASEAN members and countries from North

East Asia namely Japan, South Korea, and China. The first meeting on EAEC was in December 1995. Japan was reluctant to get involved in EAEC at the beginning.<sup>7</sup> However, when China and South Korea agreed to join the caucus, the Japanese government decided to engage in the EAEC. The tie-up of ASEAN with China would be a nightmare for Japan and the United States. The only way to salvage the formidable situation for Japan was to join the EAEC. The "new version" of EAEC is not a trade bloc but merely as a discussion group on economic matters. Even in this modified version, the idea did not fly, but neither did it die (Sastrohandoyo 2001).

In respect to Japan and the EAEC matter, Japan is less interested about the EAEC. The main reason as stated earlier is due to the factor of trade friction with the US. The second reason is because of Asia Pacific Economic Cooperation (APEC). Japan is more concerned and interested in APEC. The group is large and covers most of East Asia, Pacific and North American countries. If APEC materialises as a free trade area, it will benefit Japan, and the gain from APEC is expected to be enormous. Nevertheless, APEC still remains as an economic forum. The initiative to start or launch as a trade arrangement is far from reality. The re-emergence of EAEG in 1997 implicitly eroded APEC's moves (or agendas).

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<sup>4</sup>PR China also opposed to the Japanese proposal of establishing the AMF in September 1997. It also opposed to holding the ASEAN+3 finance minister's meeting in September 1998 (Furukawa, 2001). In the ASEAN+3 finance minister summit held in May 2000 in Chien Mai, the members of the group agreed to the currency swap basic agreement and other monetary cooperation. The swap agreement is an alternative mechanism to the AMF.

<sup>5</sup>Some of the ASEAN members (Singapore particularly) also disinclined to accept the idea since it was not consulted about it at the ministerial level.

<sup>6</sup>East Asian Economic Caucus (EAEC) was suggested by Indonesia in 1991 at the ASEAN finance minister summit. The scope of EAEC are more narrow and limited than EAEG.

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<sup>7</sup>For reasons look at the above paragraph.

In 1997 during the ASEAN summit in Kuala Lumpur, again Prime Minister Mahathir proposed an establishment of a free trade arrangement within the East Asian region. The main reasons for establishing such FTA are to increase co-operation among countries of the region and to reduce the impact of the economic crises on the four affected countries (i.e., Indonesia, Malaysia, Thailand, and South Korea). The proposal received a warm response from EA delegates. In 1999 at the ministerial summit in Manila, ASEAN, Japan, China, and South Korea agreed to form an economic co-operation, i.e., the East Asian Economic Group within 20 years. At the summit, EAEG was renamed the ASEAN+3 (China, Japan, and South Korea). The ASEAN+3 (AP3) has been recognized as an established institution. In the fourth summit in Singapore 2000, Japan gave a final recognition of EAEG even though there was an objection from the USA. Main reasons for Japan's involvement in EAEG are due to the full participation of China in the group and China admission in the WTO. While Japan is afraid of China's role in the ASEAN+3 but she may gain from economic liberalization in China.

A committee has been established to look at the opportunities and implications of the establishment of ASEAN+3 on its members. Prior to the development of ASEAN+3, Asia Pacific Economic Cooperation (APEC) was the main table for discussing

liberalisation of trade and investment. However, APEC is not looking primarily on East Asian economic integration and interest per se and the forum is dominated by US and other strong economies. In general, ASEAN+3 focuses on EA members' interests. The group plans to emulate the European Union concept.

### **ASEAN-CHINA FTA: A CHALLENGE FOR CHINA**

Zhu Rongji, Prime Minister of the PR of China, had raised the idea of an ASEAN-China FTA during the ASEAN-China Economic Cooperation Meeting (ECA) in August 2001 and at the ASEAN+3 meeting in Singapore in November 2000 (Buszynski 2001). The proposal was also made and promoted by Singapore. Other ASEAN members were very reluctant about the ASEAN-China FTA. They favored a bigger FTA that is called East Asian FTA (EAFTA), that would include China, Japan, and South Korea. However, at that moment Japan and South Korea were not ready for the EAFTA.

After six rounds of negotiations, the heads of government of China and the 10 ASEAN members had signed an accord in Phnom Penh in November 2002 which proceeded to the first phase of a planned ASEAN-China Free Trade Area into operation by 2007. By then, tariffs on more than 600 products, mainly agricultural items, comprising about 10% of all items traded between the two sides are sup-



posed to drop to zero. Under the Framework Agreement on China-ASEAN Comprehensive Economic Cooperation, China will cut import tariffs on ASEAN products a few years before these countries will reciprocate and open their own markets to China's exports. This is intended to give ASEAN an export advantage over Chinese products and to allow Southeast Asian manufacturers a time to become more efficient and productive. ASEAN officials also expect China will become a significant importer of ASEAN primary products. ASEAN's Secretary General, Rodolfo Severino, had asserted that "the overall impact of (free trade) on China and ASEAN would be beneficial. When the planned liberalization of trade in goods and services between them is completed by 2012, it will be the largest free-trade zone in the world.

The establishment of a free trade area (FTA) between ASEAN and China will create an economic region of 1.7 billion consumers, regional GDP of about US\$2 trillion and total trade is estimated at US\$1.23 trillion (Subianto 2001). The magnitude and size of its population, the GDP, and trade among them will make it the biggest FTA in the world. Moreover, the removal of trade barriers between ASEAN and China, as suggested, will lower costs, increase intra-regional trade, and increase economic efficiency. The FTA will lead to greater specialization in production based on comparative advantage. Trade creation occurs when

some domestic products in one FTA member is replaced by lower-cost imports from another member. This will boost real income in both regions as resources flow to sectors where they can be more efficiently and productively utilized. It is estimated that an ASEAN-China FTA will increase ASEAN's exports to China by 48% and China's exports to ASEAN by 55.1%. The FTA should increase ASEAN's GDP by 0.9% or by US\$5.4 billion while China's real GDP should expand by 0.3% or by US\$2.2 billion in absolute terms. Such an initiative to have an ASEAN-China Free Trade Area within the next ten years seems most likely to pose a significant impact on other non-economic sectors.

The figures which are presented above are estimations. What will be the real outcome of the FTA, i.e., the impact of the FTA on ASEAN and China, remains a question. Below is a discussion which provides some rough views as to what would be the ex-post picture of the FTA, especially to the members of ASEAN.

Chinese economy has grown rapidly since 1990s. The country's real GDP growth during the last decade had averaged 10.1%, the fastest rate of real GDP growth in the world. Furthermore, the total trade of China in the world economy had increased from 1% in 1980 to 1.70% in 1990 and in 2000 the ratio had been recorded at 4.1%. In the 1990s, both China and ASEAN achieved high growth rates

in foreign trade. From 1991 to 2000, China's foreign trade grew at an average annual rate of 15%. China's exports grew threefold from US\$62.1 billion in 1990 to US\$249.2 billion in 2000, making China the seventh largest exporter in the world; whereas foreign trade in ASEAN grew at an average annual rate of 10.9% from 1991 to 2000.

In the case of ASEAN-China trade relations, ASEAN-China trade grew at an average of 20.4% annually since 1991 to 2000. In the year 2000 total trade was US\$39.5 billion in contrast to US\$7.9 billion in 1991. China's exports to ASEAN grew from US\$4.1 billion in 1991 to US\$17.3 billion in 2000 while its import from ASEAN grew from US\$3.8 billion in 1991 to US\$22.2 billion in 2000. A joint study by ASEAN and China have found that China's exports to ASEAN will increase by US\$10.6 billion, or 55%, while its imports from ASEAN will rise by US\$13 billion, or 48% (Glosserman and Fritschi 2002). By one estimate, the FTA will add 1% to annual economic growth in the ASEAN countries and 0.3% in China (Glosserman and Fritschi 2002).

Foreign trade is an important driving force for the economic development of China and ASEAN. But ASEAN countries rely more on the exports sector for economic growth as compared to China. By looking at the above paragraph, ASEAN seems to be on the losing side. China seems to have more advantage in trading than

ASEAN. In respect to international trade, there will be a stiff competition between ASEAN and China, and the competition will be in two aspects: (1) international market penetration, and (2) competition in terms of products.

ASEAN main trade partners are United States (US), Japan and Singapore, while China main trade partners are US and Japan. Both groups competing each other exporting to same destination. In case of trading with the US, Kwan (2000) had shown that ASEAN countries has to compete more than China (and Japan) for US market (Table 1). Table 1 also reveals that ASEAN and other EA countries, their degree of competing for US market has increased since 1990s. It seems they have to put more effort to compete with China for international good market. Competition in international market, only those country which has a competing price will take a bigger

Table 1

**ASIAN COUNTRIES COMPETITION  
WITH CHINA IN THE US MARKET**

	1990	1995	2000
Japan	3.0	8.3	16.3
South Korea	24.0	27.1	37.5
Taiwan	26.7	38.7	48.5
Hong Kong	42.5	50.5	55.9
Singapore	14.8	19.2	35.8
Indonesia	85.3	85.5	82.8
Malaysia	37.1	38.9	48.7
Philippines	46.3	47.8	46.1
Thailand	42.2	56.3	65.4

Source: Kwan (2002).



slice of cake. Price is main factor determine the competitiveness of exports. Practically, only product which has a low cost of production will gain in the trade game. Table 2 shows cost of production in the selected countries. Relatively, cost of production in China is much lower than countries of East Asian. Implicitly, China will gain a positive terms-of-trade (TOT) effects and this is in contrast to ASEAN.

How about comparative advantage? Table 3 illustrates pattern of comparative advantage of EA region in year 2000. Even the pattern of comparative advantage looks less indiffer-

ent in sector SITC 6-8, yet China is still leading in that sector.

Both ASEAN and China are major producers of electrical and electronic products, and a high portion of their exports are from that sector. As a comparison, total production of electrical-electronic goods of China in 1996 was about US\$35 billion; and the figure increased to US\$50 billion in 1999. In South Korea production of the goods in 1996 was about US\$44 billion but decreased to US\$43 billion in 1999; in Singapore total production of the goods in 1996 was US\$44 billion and decreased to US\$43 billion in 1999; in

Table 2

**LABOR PRODUCTIVITY IN MANUFACTURING SECTOR  
IN SELECTED COUNTRIES (US\$/LABOR PER YEAR)**

China (1998)	USA (1995)	Japan (1993)	Germany (1994)	S. Korea (1994)	Malaysia (1995)	Indonesia (1996)
3,604	98,253	104,075	85,370	57,666	17,135	9,332

Source: Shun-ya dan Masaki (2002).

Table 3

**COMPARATIVE ADVANTAGE OF THE 10 ECONOMIES OF ASIAN, YEAR 2000**

	SITC0	SITC1	SITC2	SITC3	SITC4	SITC5	SITC6	SITC7	SITC8
China	0.93	0.56	0.64	0.51	0.77	0.62	1.28	0.61	2.96
Japan	0.06	0.10	0.20	0.07	0.03	0.77	0.74	1.76	0.74
H Kong	0.26	0.83	0.43	0.15	0.46	0.62	1.11	0.84	3.01
Taiwan	0.25	0.03	0.37	0.04	0.04	0.69	1.29	1.26	0.99
S. Korea	0.28	0.09	0.39	0.41	0.04	0.80	1.22	1.15	0.65
Indonesia	0.98	0.47	2.18	3.17	8.23	0.38	1.20	0.22	1.22
Malaysia	0.37	0.32	1.26	1.08	12.87	0.39	0.61	1.45	0.68
Philippine	0.81	0.19	0.51	0.16	5.67	0.16	0.30	0.77	0.75
Singapore	0.27	1.43	0.26	0.94	0.60	0.64	0.37	1.71	0.61
Thailand	2.76	0.33	1.25	0.31	0.26	0.47	0.79	0.98	1.32

Source: Xiaojuan (2001).

Malaysia total production of electrical-electronic goods was US\$30 billion and it had increased marginally in 1999 to US\$34 billion; and finally in Thailand total production of the sector was US\$14 billion in 1996 and it has increased slightly to US\$15 billion in 1999. Even though in case of Malaysia and Thailand the production of electrical-electronic goods had increased but the increment is lower than in the case of China. China is now one of the major world producer of mobile phones (12.9% of the world total); DVD player (38.8% of the world total), VTRs (23.2% of the world total), color TV (24.6% of the world total), air-conditioners (38.7% of the world total) and hard-disk drive (6.9% of the world total) (Atsuo 2002). Foreign direct investment in China is generally concentrated in the production of those sectors besides being involved in producing semi-conductors, laptop computers, plasma display panels (PDPs), digital camera and color liquid crystal displays (LCDs). The structure of production of electrical-electronic goods and the concentration of FDI in the production sector is similar between China and ASEAN.

In both regions, the model of development of the manufacturing sector is mainly in export-oriented goods, as it is much related to the "flying-geese" model. Therefore, competition for foreign capital and international market will be tough. In the case of ASEAN, this scenario essentially will not favor the region in the long-term.

Furthermore, foreign firms in ASEAN have started to re-locate their operation from ASEAN to China. The impact of the FTA on ASEAN is very crucial since it could deteriorate the welfare of the member economies particularly in worsening income distribution.

In relation to the trade matter, Table 4A and 4B describe the pattern of tariff on import goods in ASEAN and in China. The average tariff rate in China is 2.3% which is much lower than ASEAN which is 9.4%. On the other hand, non-tariff barriers (NTB) rate in ASEAN is 69.1% which is very much higher as compared to China which is 9.2%. ASEAN economies are more protective in contrast to China. Plans for tariff liberalization and NTB tariffication under the ASEAN-China FTA Framework will definitely result in significant injuries to inward-oriented and export industries mainly in ASEAN economies. Also under such framework, ASEAN members have been allowed to take a longer time-frame in cutting trade barriers. This longer time frame should allow members of ASEAN to take the necessary measures to counter or resolve any deterioration either in production or in the export sectors. If there is an intense competition from China, how will members of ASEAN ensure that their industries remain competitive?

Based on the discussion above, the overall picture indicates that China will gain a greater trade creation from the FTA. In the case of ASEAN, some



Table 4A

**AVERAGE TARIFF RATES OF ASEAN-6 AND CHINA,  
SELECTED MAJOR ITEM (PERCENTAGE)**

ASEAN Imports & Chinese Tariff Rates		China Imports & ASEAN Tariff Rates	
Fruits & vegetables	5.0	Fruits & vegetables	27.4
Coal	9.4	Oil seeds	21.4
Food products	5.0	Petroleum products	8.4
Electrical goods	4.8	Rice	112.8
Beverages & tobacco	6.2	Chemical, rubber & plastic products	19.2
Machinery	3.4	Electrical goods	16.6
Average	2.3	Average	9.4

Source: Chirathivat (2002).

Table 4B

**AVERAGE NON-TARIFF RATES (NTB) OF ASEAN-6 AND CHINA (PERCENTAGE)**

ASEAN Imports & Chinese NTB		China Imports & ASEAN NTB	
Mineral products	13.6	Forestry products	76.6
Dairy products	17.0	Leather products	100.0
Beverages & Tobacco	51.2	Metal products	83.7
Textiles	7.3	Rice	76.8
Other commodities	9.6	Other commodities	96.8
Average NTB rate	9.2	Average NTB rate	69.1

Source: Chirathivat (2002).

Table 5

**SOUTHEAST ASIA (SEA) AND CHINA: FOREIGN DIRECT INVESTMENT INFLOWS,  
1995-2000 (IN US\$'MIL)**

	1995	1996	1997	1998	1999	2000
Brunei	13	-69	2	-20	-38	-19
Cambodia	151	294	204	121	135	153
Indonesia	4,346	6,194	4,677	-356	-2,745	-4,550
Laos	95	160	91	46	79	72
Malaysia	5,816	7,296	6,513	2,700	3,532	5,542
Myanmar	277	310	387	314	253	240
Philippines	1,459	1,520	1,249	1,752	737	1,489
Singapore	8,788	10,372	12,967	6,316	7,197	6,390
Thailand	2,004	2,271	3,627	5,143	3,562	2,448
Vietnam	2,336	2,519	2,824	2,254	1,991	2,081
SEA Total	25,285	30,867	32,541	18,270	14,703	13,846
SEA as % of Developing Asia	34.3	34.5	33.0	21.2	15.3	10.1
China	35,849	40,180	44,237	43,751	40,319	40,772
China as % of Developing Asia	48.7	44.9	44.9	50.9	41.9	29.7

Note: Developing Asia includes South, East, and Southeast Asia.

members may gain but not as great as China, and some members may face considerable losses due to their involvement in the FTA.

The second aspect in which ASEAN may face difficulties or losses under the FTA is in attracting FDI. The policy of "opening economy" since the era of Diang Xiopeng, has enhanced economic expansion of China. The rapid economic growth in China has been substantially generated by foreign capital. Foreign-affiliated companies account for 30% of industrial production and 50% of industrial exports; and they also hold a large share of corporate earnings (Watanabe 2002; Kwan 2002; Lardy 2002, 7). The country's GNP is very far below her GDP, and this makes China attractive to foreign capital as an export bases. According to Watanabe (2002), China's economy is heavily dependent on foreign capital, and its dependence is even greater than other East Asian countries.

FDI inflows into China had grown more than tenfold from US\$3.5 billion in 1990 (about 10% of all FDI flows to developing countries) to US\$40.77 billion in 2000 (17% of all FDI flows to developing countries) (Table 5). At the beginning of the 1990s, Southeast Asia took 61% of all direct investment flows to developing countries in Asia, while China received 18%. Within a decade, the proportions had been reversed; China took 61% of FDI, while ASEAN states claimed but 17% (Glosserman and Fritschi 2002).

Besides the overall decline of FDI in ASEAN, it should also be noted that its share of Asian bound FDI had decreased from 60% to 20%. In 1992, both ASEAN and China received similar amounts of FDI but while ASEAN FDI peaked in 1996 at US\$28.8 billion and then declined, China's FDI increased to around the US\$40 billion level.

ASEAN FDI was undoubtedly affected negatively by the financial crisis, while China offered a stable alternative. It was predicted that the trend of rising investment into China would not bode well for ASEAN. FDI flows into China are expected to reach US\$18 billion in 2003. An investment boom in China has been similarly predicted as China entered WTO membership in 2001. Already over the period of January-July 2001, China's FDI had surged 21% to reach US\$24.2 billion (Buszynski 2001). Most of the world's FDI to Asia has penetrated to China. What will happen to East Asian economies which are trade dependent and rely on foreign capital for economic growth? In respect to FDI, this is a crucial question to members of the ASEAN-China FTA since all of them are trade dependent economies.

## CONCLUSION

The establishment of ASEAN-China FTA is almost welcome by East Asian communities. The FTA sounds very impressive but it remains to be seen



— what is the cost of the FTA to the members which are uncompetitive. Beforehand, a feasibility study should be done thoroughly to inspect the cost of trade diversion and competitiveness. Definitely, there are members of the pact who will gain and also there are members who will lose. If there is a high cost of FTA to some members, therefore the committee of the FTA should construct a mechanism which can compensate the losses to the losing member. This is vital to ensure stability and harmonization of the group. The ASEAN-China FTA could become a large free trade arrangement in the world. However, if some members of the pact experience losses, it will accordingly dent the pact.

In general, all members of the ASEAN-China FTA are developing countries. FTAs—which integrate together industrialized and developing countries, such as NAFTA and EU—are different than the group only consisting of developing countries. The pattern of trade, investment, employment or income distribution of both FTAs look different. Usually, developing countries compete among themselves in trading and they struggle to get a bigger bite of the international market besides attracting foreign capital. Foreign capital and the international goods market are the major sources of economic growth for a developing country including ASEAN and East Asian countries. Until now since the ASEAN-China FTA launched in November 2002, there is no explicit

effect of the pact to the members. But, based on rough anticipation, some members may be losing from the game.

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## JENDERAL PEMIKIR DAN DIPLOMAT

*(Studious General and Diplomat)*



*Edited by:* Clara Joewono, Edy Prasetyono, Hadi Soesastro.

*Published by:* Centre for Strategic and International Studies (CSIS), Jakarta.

This volume is a compilation of 27 papers written by Hasnan Habib's friends, including a number of CSIS researchers, as a birthday present in celebrating Hasnan Habib's 75<sup>th</sup> birthday.

Those papers are organized into 3 parts: (I) *Tentang Hasnan Habib* (On Hasnan Habib); (II) *Bunga Rampai Pemikiran dan Masalah Kebijakan* (Policy Issues and Other Miscellaneous Ideas); and (III) *Masalah Regional dan Internasional* (Regional and International Issues).

*Contributors:* Toeti Adhitama, Soemitro (Alm.), Hasjim Djalal, Ninok Leksono, Muhamad A.S. Hikam, Clara Joewono, A.A. Banyu Perwita, M. Sadli, Daoed Joesoef, Bantarto Bandoro, Edy Prasetyono, Landry Haryo Subianto, Djisman S. Simandjuntak, Sabam Siagian, Hadi Soesastro, Pande Radja Silalahi, M. Djadijono, Kusranto Anggoro, Agus Widjojo, Rizal Sukma, C.P.F. Luhulima, J. Soedjati Djiwandono, Philips Jusario Vermonte, Ikrar Nusa Bhakti, Jusuf Wanandi, Lina A. Alexandria, Dewi Fortuna Anwar.

2003. 1<sup>st</sup> Ed., xiv + 366 pp.; 25 cm, ISBN 979-8026-81-0

Rp 70.000,00 + postage charge 15% for Indonesia

US\$29.00 + postage charge by airmail for overseas

Centre for Strategic and International Studies

Jalan Tanah Abang III/23-27, Jakarta 10160, Tel 386-5532, Fax 380-9641, 384-7517

Email: csis@csis.or.id



# Indonesia's Experience in Facilitating Peace Process

*Teuku Faizasyah*

## INTRODUCTION

THE settlement or resolution of an international conflict is subject to a number of factors. Some of the factors are from within the conflict (internal), such as the dynamics within the stakeholders and the developments of the problems after such a period of time, while others are external to the conflict. The external factor mostly revolves around the role of the third party in assisting the conflicting parties in the overall peace process.

To argue a third party as a factor in the peace process is not without foundation. There were cases where the third parties were very instrumental in the peace process and were able to influence the dynamics of conflicts and the relationships between the stakeholders. For instance, peace settlement between Egypt and Israel, more than two decades ago, owed to a greater extent to President Jimmy Carter's role. The success of President

Carter is often attributed to his charisma and the leverage that the US has on the two countries and the amount of resources that the US possesses to influence the stakeholders.

However, not all third parties are blessed with this combination of leverage and having a charismatic leader. Still, they were effective in assisting the conflicting parties in achieving peace. Indonesia's role as peacemaker at regional level in dealing with the Cambodian and Moro (southern part of the Philippines) problems is an interesting case for analysis. In both cases, Indonesia's leverage over the stakeholders was moderate and moreover, the notion of charismatic leader was not the dominant feature during the overall peace process. The question on this issue is: what made Indonesia successful in assuming that role?

The central argument of this article is that although the internal dynamics of the conflicts in Cambodia and Moro were prone to change, Indonesia's role

as a third party remained essential. Factors responsible for Indonesia's success in paving the way for conflict settlement include the eagerness of the Indonesian Foreign Ministry's bureaucracy to achieve tangible results from diplomacy and the efficacy of their overall approaches: the combination of informal and formal diplomatic approaches. Moreover, a synergy of interest between President Soeharto and the Indonesian Foreign Ministry (the Ministry) for diplomatic achievements had further strengthened the diplomatic efforts.

This article consists of four main sections. The first provides historical analysis of the two regional conflicts under study. The second outlines the internal dynamics of the third party, that is, the dynamics of the Soeharto Government in the 1980s and 1990s. The third assesses the peace processes and their outcomes. The last section summarizes the discussion, especially by reflecting on the best practices and the lesson learnt from Indonesia's experiences, and seeing those lessons in the context of Indonesia's domestic problems of armed conflicts and separatism.

## HISTORICAL OVERVIEW OF THE CAMBODIAN AND THE MORO CONFLICTS

### The Cambodian Conflict

The focus here is the Cambodian conflict that occurred after Vietnam, one of the regional powers, occupied

its neighbor in 1979. However, it is necessary to note that the conflict needs to be examined in the context of a domestic struggle for power or an internal feud that took place almost ten years before Vietnam moved into Cambodia. The cause of the feud was the differing perception of Prince Norodom Sihanouk and his armed forces in coping with the impact of the Vietnam war on their country in the 1960s — the Second Indochina war (from the early 1960s to the mid-1970s) between North and South Vietnam involving the United States, China and the Soviet Union. This differing perception led to a coup in 1970 which brought Lon Nol to power. From 1970, Cambodia was plunged into civil war.

The armed conflict and the cycle of violence in Cambodia were made worse through the involvement of the major powers who used the factions in Cambodia as their proxies. The Lon Nol government (1970-1975) faced insurgencies from the coalition forces of the National Liberation Front under Prince Sihanouk and the Khmer Rouge.<sup>1</sup> The coalition forces received

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<sup>1</sup>Khmers Rouges (Cambodian Reds) according to Prince Sihanouk is "a loose description of communists and other leftists, at one time in opposition to the Royal Government, now an important component in the Cambodian National United Front and the resistance [that is, against Lon Nol's government.] Norodom Sihanouk and Wilfred Burchett, *My War with the C.I.A.: Norodom Sihanouk as related to Wilfred Burchett* (Harmondsworth: Penguin Books Ltd., 1973), footnote no. 1, 28.



military training and assistance, and were given sanctuary by China and North Vietnam. The US backed the Lon Nol government by providing military assistance including launching a massive bombing campaign in Cambodia to destroy the resistance forces, in particular the Khmer Rouge. The Khmer Rouge blamed Vietnam for Cambodia's devastation from the US bombing raids in 1973 on the grounds that the bombing took place after Vietnam and the US had agreed on a partial cease-fire in South Vietnam and a permanent one in Laos.<sup>2</sup> This alleged 'sell-out' to the US was regarded as a factor that triggered hatred among the Khmer Rouge leaders towards Hanoi.<sup>3</sup> The military incursion of the Vietnamese in 1979 had further complicated the factions rivalry in Cambodia.

Broadly defined, the parties and stakeholders to the Cambodian conflict were those who fought for victory in the battle and the diplomatic fields. If on the battlefield, the warring factions were relatively easy to identify; on the diplomatic front the stakeholders of the conflict were more diverse and

fluid. On the battlefield, the resistance groups consisted of the Khmer Rouge under Pol Pot; the Khmer People's National Liberation Forces (KPNLF) under Son Sann; and the United Front for an Independent, Neutral, Peaceful and Cooperative Cambodia (FUNCINPEC) under Prince Sihanouk. These resistance groups fought against the People's Republic of Kampuchea (PRK) with the backing of the Vietnamese occupation forces.<sup>4</sup> China provided Khmer Rouge forces with more military assistance compared to its assistance to FUNCINPEC. The KPNLF faction, whose military officers were members of the defeated Lon Nol regime before 1975, received only token military assistance from some ASEAN and Western countries.<sup>5</sup>

In general, the stakeholders in the Cambodian conflict as well as its settlement can be divided into two broad classifications, the inner and outer circles. *The inner circle* consisted of those three resistance factions and the People's Republic of Kampuchea as well as countries engaged directly in the conflict, that is, Vietnam, Thailand and China. *The outer circle* involved those regional countries concerned with the prospect of conflict escalation and its potential to en-

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<sup>2</sup>To illustrate the massiveness of the US bombing, Grant Evans and Kelvin Rowley noted that in 1973 the US dropped more than 250,000 tons of bombs on Cambodia in six months, whereas the US dropped 160,000 tons of bomb on Japan in six years of war. Grant Evans and Kelvin Rowley, *Red Brotherhood at War: Indochina since the Fall of Saigon* (London: Verso, 1984), 102.

<sup>3</sup>Sihanouk and Burchett, *My War with....*

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<sup>4</sup>After April 1989, the People's Republic of Kampuchea was named the State of Cambodia (SOC).

<sup>5</sup>See Al Santoli, "Endless Insurgency: Cambodia", *The Washington Quarterly* (Spring 1985): 61-72.

danger regional stability. As a regional grouping, ASEAN also had a stake because the conflict threatened the principles of ASEAN, especially those of non-interference and the inviolability of national sovereignty.<sup>6</sup> Clearly, the invasion and the installment of puppet government in Cambodia challenged ASEAN's credibility as a regional grouping that promoted a regional code of conduct. Michael Leifer portrays ASEAN feelings by stating: "ASEAN could not ignore Vietnam having conveyed a government into Kampuchea virtually in the saddle bags of its invading army without a serious loss of international credibility."<sup>7</sup> Hence, ASEAN had to respond to the conflict post-invasion. Similarly important, the urgency of finding a solution to the Cambodian conflict increased over time because the conflict created strains in the relations of some ASEAN members.

### The Moro Conflict

In brief, separatism in the southern part of the Philippines stemmed from the Moro's frustration following decades of oppression under the Spaniards and the Americans, and a sense

of being neglected by successive Philippines Governments. In 1968, the Moro declared their independence from the Republic of the Philippines and a year later, they established the Moro National Liberation Front (MNLF) as their military force. The Philippines government responded to the declaration with military operations that received strong criticism from Islamic countries. Libya and Saudi Arabia had raised the Moro problem to the attention of the OIC during the Third Ministerial Conference in Jeddah, Saudi Arabia, in March 1972.

Some OIC members, either deliberately or discreetly, supported the MNLF struggle. The Libyan leader, Muammar Khaddafi and the Chief Minister of Sabah, Malaysia, Tun Mustapha, gave the Moro support, armaments and sanctuary in Sabah. Saudi Arabia also threatened to cut its oil supply to the Philippines unless the GRP reversed its policy towards the Moro people and showed more leniency towards the MNLF.<sup>8</sup> The OIC pressures, coupled with a concern over oil supplies, forced the GRP to come to Tripoli in 1976 to hold a meeting with the MNLF.

The Tripoli Agreement of 1976 called for the immediate cessation of all hostilities and stipulated several

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<sup>6</sup>In their pursuit for regional co-operation and relationships ASEAN had developed a code of conduct as a governing principles and ASEAN hoped that the regional countries were willing to respect the code of conduct. See Michael Leifer, *ASEAN and the Security of South-East Asia* (London: Routledge, 1989), 89.

<sup>7</sup>*Ibid.*, 93.

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<sup>8</sup>See Ivan Molloy, "The Decline of the Moro National Liberation Front in the Southern Philippines", *Journal of Contemporary Asia* 18, no. 1 (1988): 61-62.



provisions. One of the provisions asked the GRP to give the Moro autonomy over thirteen provinces and, in another provision, the Philippines' constitutional obligation with regard to the Agreement was recognized. Article 16 of the Agreement stated that "[t]he Government of the Philippines shall take all necessary constitutional processes for the implementation of the entire agreement."<sup>9</sup> After Tripoli, the MNLF demanded the 13 provinces be accredited a status of autonomous region, automatically without condition, whereas the GRP insisted that such a status could only be accorded after a referendum. The GRP justified their position based on Article 16 of the Agreement. Thus the agreement reached in Tripoli was far from conclusive and was open to different interpretations between the protagonists.<sup>10</sup> These differing interpretat-

ions became a bone of contention between the two parties.

## INDONESIA AS A THIRD PARTY: INTERNAL DYNAMICS

Internal dynamics in this case refer to a set of conditions inside the third party, which has increased the third party's capacity in assuming their facilitation function. In Indonesia's case, the internal dynamics include the interest of the Ministry to increase their leverage on foreign-related issues at the domestic level and President Soeharto's personal interest to increase his international stature. In the mid-1980s and 1990s the interest of the two were entangled.

The Ministry's interest to increase its leverage at the domestic level was a result of their moderate capacity to influence foreign policy making and its implementation during the first half of Soeharto's presidency. During the Soeharto era, foreign policy making was undoubtedly elitist and characterized by bureaucratic politics. The President allowed the

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<sup>9</sup>Article 16 of the Tripoli Agreement of 1976, dated 23 December 1976.

<sup>10</sup>It is important to note that one-year after Tripoli meeting, differences in interpretation of the provisions during the implementation stage already observable. The Indonesian delegation to the OIC ministerial meeting in Tripoli, Libya, 19 May 1977, asked the OIC to play its role wisely and to balance the interests of the MNLF and the GRP. Statement by Mr. Adam Malik, Indonesian Foreign Minister to the 8th Islamic Conference of Foreign Ministers, Tripoli, Libya, 19 May 1977. *Pewarta*, April-June 1977, No. 2. It is also important to note that after Tripoli Agreement of 1976, there was a split in the MNLF, between those who supported and rejected the autonomy. Those who rejected the autonomy formed the Moro Islamic Liberation Front (MILF) un-

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der Hashim Salamat, and the Moro National Liberation Front Reform under Dimas Pundato. They accused Misuari of betraying the Moro people through accepting autonomy and not insisting on independence. This sense of insecurity, from its own ranks, was one of the reasons why Misuari sought sanctuary in Saudi Arabia. Mr. Rahardjo Mustajab, former Head of Political Section, Indonesian Embassy in Manila, provided information concerning Misuari's plight. Interview, 4 October 2001.

foreign policy making elite to compete for his favor and, in the end, he decided which course of action would be taken. The domination of the President was a result of the pyramidal shape of Indonesia's political structure in which Soeharto sat at the apex. William Liddle describes the political structure of the Soeharto government as follows:

The political structure of the New Order can be described as a steeply-ascending pyramid in which the heights are thoroughly dominated by a single office, the presidency. The president commands the military which is *primus inter pares* within the bureaucracy, which in turn holds sway over the society.<sup>11</sup>

The elitist nature of the process made foreign policy making distant from the society at large. At times, the President made decisions merely to appease the various interest groups or the competing elites. Robert Tilman argues that decisions on foreign policy were not necessarily taken for the sake of national or societal interests, but to accommodate or balance the competing interests among factions, usually among government bureaucrats.<sup>12</sup> In this case, Presid-

ent Soeharto made the final decision to satisfy the competing elites, so that the substance of the policy was not too important.

Nevertheless, domestic political stability under Soeharto created an environment wherein the government apparatus was able to structure, formulate and pursue their ministries' programs. The then political environment favored the continuation of policy from year to year because the bureaucrats were able to pursue a policy relatively free from interference from other centers of power, such as from members of parliament and opinion makers. However, this process was not immune from constant competition among the foreign policy making elite in attaining some policies.

Needles to say, although foreign policy making went through a complicated process, the final say of the outputs always rested with President Soeharto, based on his prerogative right. Logically, in the cases where the initiative taken by the bureaucrats would have enhanced the President's profile internationally and domestically, the President would have given it his full support.

At first, the Ministry's bureaucrats were not Soeharto's favorites. When Soeharto came to power, he showed a lack of trust toward professional diplomats from the Ministry. In order to 'cleanse' the Ministry of those

<sup>11</sup>William Liddle, "Soeharto's Indonesia: Personal Rule and Political Institutions", *Pacific Affairs* 58, no. 1 (Spring 1985): 71.

<sup>12</sup>Robert O. Tilman, *Southeast Asia and The Enemy Beyond: ASEAN Perceptions of External Threats* (Boulder: Westview Press, 1987), 39.



whom he perceived as leftist or Soekarno followers, Soeharto installed military personnel in the Ministry. The military were placed in some strategic positions in the Ministry and some important overseas posts were given to them, among others, ambassadorships in ASEAN capitals, Tokyo and Washington.<sup>13</sup> The domination of the military in the Ministry suggests that in his early years Soeharto was more concerned with the stabilization program and securing various bureaucracies, military establishment, political parties and social organizations from the remnants of the Indonesian Communist Party. However, Soeharto also realized the importance of foreign policy to secure his development program and to renew regional and international confidence on Indonesia post-Soekarno.

To secure his foreign policy objectives, Soeharto assigned Adam Malik, a senior politician, as Indonesian

Foreign Minister. Minister Malik who led the Ministry from 1967 to 1977 inherited a bureaucratic system where their personnel had gone through security clearance, and were rather low in spirit. Clearly, the diplomatic corps in the Ministry experienced regression after some of their compatriots were purged and, at the same time, foreign policy was not high on the agenda of the New Order government which gave priority to stabilization of the domestic front. In dealing with this apathy among the personnel, Minister Malik nurtured a new cadre of professional diplomats among those who remained in the Ministry and embarked on a policy of recruitment. Those who were recruited had undergone intensive training and were encouraged to pursue post-graduate studies overseas. All ministers, after Minister Malik, continued the Ministry's policy on training and education.

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<sup>13</sup>However, for some military generals ambassadorial posts did not necessarily mean promotion or they had received President's personal favor. There were cases where an ambassadorship was Soeharto's effort to distance some generals from domestic politics and was popularly called in the Indonesian language as *pos pembuangan* (asylum post). An example of this was General Soemitro who was offered ambassadorship after Malari's affair, but he declined the offer. In a different case, Lt. Gen. (ret.) Sarwo Edhie was sent as Indonesian Ambassador to Seoul, South Korea, because he had criticised Soeharto's policy. See Peter Kasenda, "Sarwo Edhi Wibowo dan Operasi Militer: Penghancur Gestapu/PKI dan Pendobrak Orde Lama," *Prisma*, Edisi Khusus 20 Tahun Prisma, 1991, 159-176.

The success of Minister Malik, with the help of professional diplomats, in achieving Soeharto's objective of creating new image of Indonesia in the region, particularly through the establishment of ASEAN did not necessarily raise the Ministry's profile in Soeharto's eyes. Up to the mid-1970s, the military establishment had Soeharto's favor and retained its favored position. An example of this was the Ministry's position vis-à-vis the incorporation of East Timor into Indonesia in 1976. To the Ministry's embarrassment, they were left out of the loop of the *operasi Ko-*

*modo* (Komodo operation), when the 'Indonesian volunteers' infiltrated East Timor in 1976.<sup>14</sup>

The East Timor debacle had deteriorated Indonesia's image internationally and in order to improve the image, Soeharto looked for possible diplomatic avenues to impress the international community. Meanwhile, conflicts in Cambodia and the southern-part of the Philippines presented Indonesia with problems "close to its doorstep." Hence, there was urgency for Indonesia to respond to the problems. For the Ministry, these regional problems gave them the opportunity to perform their professionalism and to gain the confidence of the President. Likewise, by the time the Ministry engaged in the peace process, they had sufficient cadres who were skillful diplomats and, at the same time, some of them were exposed to various perspectives on diplomacy and conflict resolution from their diplomatic training and overseas studies.

## PEACE PROCESSES IN CAMBODIA AND IN MORO

### Cambodia's Peace Process

From the very outset it is important to mention that the Cambodian conflict put Indonesian and ASEAN

interests in collision. To a certain extent, the differing threat perceptions among the ASEAN members also influenced how individual states reacted to the Cambodian conflict. ASEAN subscribed to the inviolability of national sovereignty and, therefore, regarded Vietnam's invasion of Cambodia as having to be challenged unconditional. Such aggression made ASEAN's goal of having a peaceful and stable region look unattainable.<sup>15</sup> As a member of ASEAN, Indonesia had to support ASEAN's strategy of isolating Vietnam, at all costs, and use all diplomatic means to achieve this strategy.

Meanwhile, Thailand—ASEAN's member that felt threatened by the presence of Vietnam's troops near its border—channeled arms supply from China to the resistance forces in Cambodia in order to put an extra burden on Vietnam and its occupational forces. The objective of this strategy was to 'bleed Vietnam white' in order to force Vietnam to back down and meet ASEAN's demand to retreat from Cambodia. However, Indonesia did not consider a weak Vietnam would serve Indonesia's interest for having a strong country acting as a 'buffer' against potential threats from China.<sup>16</sup> Indonesia

<sup>14</sup>See James Cotton, "Parts of the Indonesian World: lessons in East Timor policy-making, 1974-76", *Australian Journal of International Affairs* 55, no. 1 (April 2001): 121.

<sup>15</sup>See Rizal Sukma, *Indonesia and China: The Politics of a Troubled Relationship* (London: Routledge, 1999), 180.

<sup>16</sup>By then, China was regarded as posing a potential threat to Indonesia. For detail analysis, see Sukma, *Ibid.*



also did not consider the strategy of isolation was effective and observed that instead of backing down, Vietnam had hardened its stand. In 1982, for instance the Vietnamese Foreign Minister Nguyen Co Thach had stated that ASEAN hostility towards Vietnam, Laos and Cambodia would make the Vietnam government "resort to its right to self-defense."<sup>17</sup> Therefore, Indonesia considered an alternative policy of assigning certain ASEAN countries to engage Vietnam in a dialogue would yield better results in the long run, rather than the policy of isolation.

To deal with the dilemma it faced from the Cambodian conflict, the Indonesian Government maintained an open-minded attitude. Foreign Minister Kusumaatmadja came up with the idea of holding an informal meeting, held on the basis of 'equal footing, without preconditions and with no political label'.<sup>18</sup> The informal meeting would consist of two

stages: (1), a meeting between the CGDK and the Heng Samrin Government, and (2) a meeting between the Kampuchean factions involving ASEAN, Vietnam and Laos. The proposal for informal meeting, which was latter on named Jakarta Informal Meeting (JIM) was not easy to sell. In particular, Indonesia was hindered by its lack of direct access to the main players in the conflict. Thus, the success of Indonesia's effort to bring all the parties to Jakarta depended on its ability to persuade the protagonists of the usefulness of an informal meeting. For instance, Prince Sihanouk was willing to come to Jakarta for the First JIM not as a participant but as a personal guest of President Soeharto. To a certain extent, Indonesia also had to rely on the good will of Thailand and Vietnam who had leverage over some factions.<sup>19</sup>

The notion of leverage was an interesting aspect of the overall peace process involving Indonesia. On the one hand, by not having leverage over the factions and concerned countries, Indonesia had the benefit of appearing as a neutral third party, who

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<sup>17</sup>Patrick Raszelengberg and Peter Schier, *The Cambodian Conflict: Search for a Settlement, 1979-1991 - An Analytical Chronology* (Hamburg: Institute of Asian Affairs, 1995), 55.

<sup>18</sup>The discussion of the 'cocktail party' as a meeting format was held in private and involved small numbers of the Ministry's officials. Mr. Soendaroe Rachmad provided this information. In mid-1980s, Mr Rachmad was Minister Kusumaatmadja's private secretary (interview, 1 November 2001). Mr. Juwana, former Indonesian Ambassador to China, confirmed this information (interview, 19 October 2001).

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<sup>19</sup>The Permanent Secretary of Thailand Foreign Ministry, Mr. Kasemsri, during a briefing to ASEAN Ambassadors in Bangkok on 20 June 1988, stated that he would invite the CGDK's factions to his office and would remind them of their moral obligation to come to Jakarta. Cable from Indonesian Embassy in Bangkok, dated 21 June 1988. Archive-Puskom Deplu.

mainly acted as facilitator and only able to offer facilities, expertise and presided over the meetings. On the other hand, with limited leverage, Indonesia's diplomatic efforts were subject to Thailand, Vietnam and China's co-operation. As long as these countries —*the inner circle*— considered their interests and positions were not being served by any peace discussion, they would not give their utmost support to any peace initiative by a third party.

Despite all the difficulties in persuading the stakeholders to come to Indonesia, Indonesia hosted two JIM. The first JIM took place from 26-28 July 1988 and the second JIM, from 19-21 February 1989. In a nutshell, the two JIMs were successful in bringing all the Cambodian factions in one meeting for the first time and breaking the psychological boundary that prevented them to meet face to face in the past. The two JIMs were successful in specifying the internal as well as the external aspects of the conflict. M. Nagendra Prasad states that "as a result of the JIM I and II talks, the internal and external aspects of the Cambodian problem came to be distinguished from each other."<sup>20</sup> The concerted international efforts post-JIMs, including the Paris International Conference on Cambodia

(PICC) of which Indonesia and France jointly chaired, dealt with the two issues in tandem.

To work around the internal and external aspects of the conflict, some countries 'chipped in' and proposed a number of proposals into the peace process. For instances, the Soviet Union, supported by the US, proposed the implementation of a moratorium on arms supply to the conflicting parties. Australia, on its part, proposed that the UN function as an interim government in Cambodia. The Australian proposal dealt with one of the five main points of contention during the PICC, that is, *the Interim Authority in Cambodia prior election*. To gain support for its proposal, Australia sent Michael Costello, Deputy Secretary, Department of Foreign Affairs and Trade, on overseas tours. Hoping to find a breakthrough in the stalemate on the question of interim government, Foreign Minister Ali Alatas of Indonesia considered the Australian proposal could be used as a basis for discussion during an informal meeting involving parties to the conflict.

Indonesia hosted another informal meeting, the Informal Meeting on Cambodia (IMC) to discuss some outstanding issues not resolved in Paris and also to ponder on the Australian proposal. The IMC took place from 26-28 February 1990 in Jakarta and was jointly chaired by Indonesia and France. Australia took

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<sup>20</sup>M. Nagendra Prasad, *Indonesia's Role in the Resolution of the Cambodian Problem* (Aldershot, Hampshire: Ashgate Publishing Ltd., 2001), 137.



part in the meeting as a resource delegation. The IMC was designed as an interim meeting prior to the international conference in Paris. Unfortunately, the IMC failed to move the parties to the conflict and concerned countries forward. By adopting unanimity ruling, the meeting was not successful in producing any agreement because the Khmer Rouge rejected the inclusion of the word 'genocide' in the document entitled 'possible points of common understanding' which was designed as a basis of discussion during IMC.<sup>21</sup> Some other issues of contention included the question of Vietnamese withdrawal because it was held without international supervision, the establishment of a Supreme National Council (SNC), and an enhanced role for the United Nations in a peace settlement.

After the IMC, more diplomatic efforts were initiated to resolve the Cambodian conflict, both at regional and international levels. The diplomatic initiatives at the two levels reinforced one another, with each filling the gaps left at the other level. On one level, the P-5 were determined to develop the framework for a peace agreement. However, Indonesia and the ASEAN countries did not want the P-5 to commit a similar error to

that which had happened in Afghanistan, when the Soviet Union reached a decision with the concerned countries on the peace terms for Afghanistan without consulting the conflicting parties among the Afghans. The end result of the Soviet Union's approach was civil war, which Indonesia and the ASEAN countries did not wish to happen in Cambodia.

In this regard, ASEAN through Indonesia and France as the Co-chair of the PICC held a meeting to consult with the factions and the concerned countries about the content of the peace framework agreed upon by the P-5, during their Sixth Meeting in New York on 28 August 1990. The consultation meeting took place in Jakarta from 9-10 September 1990. At the end of the informal meeting, the participants representing the four Cambodian factions asserted their acceptance of the peace framework formulated by the P-5 in its entirety.<sup>22</sup> Moreover, the Cambodian participants also agreed in principle to form the SNC, consisting of 12 Cambodians, and to accept Prince Sihanouk as the 13th member to chair the SNC.

The change in the attitudes of the Cambodians stemmed from developments that had taken place at the regional and international levels, such as rapprochement between the

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<sup>21</sup>Based on the "Unofficial Summary Record", Informal Meeting on Cambodia, Jakarta, 26-28 February 1990. Archive - BALITBANG Deplu.

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<sup>22</sup>See Raszelengberg and Schier, *The Cambodian Conflict*, 393.

US and Vietnam and a shift in Chinese and US policy (they had direct contact with the Hun Sen led-government). In September 1990, the Cambodian UN seat was left vacant because the Cambodians were by then at loggerheads on the composition of the SNC. This event was a critical juncture for the Cambodians because the international community began to lose patience. The earlier sign of international fatigue was observable on March 1990 when the Thai Prime Minister Chatichai Choonhavan asked his cabinet to develop a plan to repatriate around 300,000 displaced Cambodians living in camps along the Thai-Cambodian border. Patrick Raszelenberg and Peter Schier argued that the Thai decision was prompted by Thai impatience with the Cambodian resistance due to their lack of flexibility during the IMC.<sup>23</sup>

By August 1991, the peace process had reached its final stage where the international efforts under the PICC process and P-5 were complemented by the efforts among the Cambodians in the SNC. The synergy between the two processes helped further the peace process because the Cambodians were involved in the discussion of the substance of the peace framework. Their involvement in the discussion of the framework was essential because a mere acceptance without knowing the sub-

stance and participation in the discussion would imperil the peace agreement. The Cambodians would feel that they had reached an agreement under international pressure and terms. In the end, the synergy of all efforts at resolving the Cambodian conflict culminated in the signing of Paris Peace Agreement on 23 October 1991.

### The Moro Peace Process

Indonesia acted as facilitator in the Moro peace process at the request of President Fidel Ramos. Upon receiving the request, the Ministry sought support from President Soeharto. On 15 December 1992 President Soeharto, through the Minister for State Secretary, Moerdiono, extended his approval.<sup>24</sup>

President Soeharto's approval cleared the way for the Ministry to develop and pursue a plan on how to facilitate the peace process, including the adoption of informal diplomacy as diplomatic instrument. The informal meeting between the GRP and the MNLF was held from 14 to 17 April 1993 in the Cipanas Presidential Palace. Although the meeting was a continuation of the exploratory talks held a year earlier in Tripoli, the informality of the meeting had a special meaning for Indonesia.

<sup>23</sup>Ibid, 308.

<sup>24</sup>Based on Minister Moerdiono's letter to Minister Alatas, dated 15 December 1992. Archive - Dit. ASPAS Deplu.



According to former Foreign Minister, Ali Alatas, it was very important for Indonesia: (1) to assess, whether or not the conflicting parties really wanted to negotiate, and (2) to measure their level of acceptance of Indonesia as the third party.<sup>25</sup> The informal format would give Indonesia a better opportunity to explore the two issues. Mr. Alatas also argued that informal diplomacy was not replacing formal diplomacy, but was a necessary given the nature of the problem.<sup>26</sup> The Cipanas Meeting was successful in clustering the contentious issues for further deliberation in the peace process.

It is important to note that Indonesia organized the informal meeting somewhat differently to the experience in Libya. First, the venue for the meeting was considered important. The Cipanas Palace was conducive for such a meeting because it is serene, and also dignified.<sup>27</sup> During the Tripoli meeting, the venue had been the office of the Libyan Ministry of Foreign Affairs. Presumably, the Philippines delegation would not feel at ease meeting with the MNLF in the office of a country which favored

the Philippines' opponents. Secondly, to make the meeting more meaningful for the conflicting parties and also to testify the seriousness of Indonesia, Minister Alatas himself opened the meeting. In contrast, officials at the level of Under-secretary had opened the meeting in Tripoli, and officials at the director level witnessed the consultation itself, whereas in Indonesia, the Director General for Political Affairs was presented during the meeting. By opening the meeting himself and assigning a high level official to assist the dialogue, Minister Alatas was, in effect, expecting the conflicting parties to engage in meaningful discussion.

The series of formal meetings after Cipanas did not render the obsolete informal format. Between 1993 and 1996 the peace process took the form of formal negotiations at the level of leaders, consultations at the level of senior officials and, at some points, seminars to disseminate information to the public. According to Dr. Hassan Wirajuda, after Cipanas, the formal and informal diplomacy were inseparable, as both were used in tandem.<sup>28</sup> In this case, Dr. Wirajuda was referring to informal diplomacy as a negotiation technique to reach an agreement on issues unresolved in a formal negotiation setting.<sup>29</sup>

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<sup>25</sup>Interview, dated 14 November 2001.

<sup>26</sup>*Ibid.*

<sup>27</sup>The decision to use the Cipanas Palace was made by President Soeharto himself. The Ministry initially suggested the Bogor Palace based on practical reason because the palace is not far from Jakarta. The Bogor Palace is also serene and in 1994 was used for the Asia Pacific Economic Cooperation (APEC) Economic Leaders' meeting.

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<sup>28</sup>Interview, 3 November 2001.

<sup>29</sup>As a concept informal diplomacy during the formal talks was understood in

Between 1993 and 1996, the Ministry was preoccupied with the peace process. Within these years, the aspect of continuity of involvement and familiarity with the issues involved were the two most significant aspects of Indonesian diplomacy in helping to settle the separatism conflict in the Southern part of the Philippines. To maintain continuity in the Indonesian team, Minister Alatas kept the Ministry team intact, in particular the Chief facilitators, Mr. Wiryono Sastrohandoyo<sup>30</sup> and Dr. Wirajuda.

The three layers of negotiation adopted by Indonesia were both strategic and practical.<sup>31</sup> It was clear that the intention was to let the experts or officials from the two parties discuss

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a number of ways. Informal diplomacy was interpreted as diplomatic activities behind the scene, to achieve certain objectives and was relied on good networking. Further, informal diplomacy was understood as a diplomatic technique to resolve conflict and also as a process to improve relationships. Furthermore, informal diplomacy was simply a negotiation technique.

<sup>30</sup>Mr. Sastrohandoyo kept chairing the formal talks, even after he was appointed as Indonesian Ambassador to Paris in 1993 and also after he was transferred to serve as Ambassador to Canberra in 1995.

<sup>31</sup>When asked about the reason of structuring the negotiations, Mr. Sastrohandoyo stated that that was the most practical approach in dealing with such a complicated conflict like in the Philippines. He indicated that clustering issues is one of the negotiation techniques that the diplomats frequently used. Interview, 22 October 2001.

the issues under the cluster exhaustively among themselves, and Indonesia chaired the discussion on behalf of the OIC. The technicality of some issues indeed required in depth study, and they needed to consult experts from other countries on some of the issues, for example on how to set up an Islamic Banking system. The essence of this approach was to give the parties to the conflict more opportunities to meet one another, and hopefully they could better understand each other and improve their relationship. This approach also guaranteed more and better results, albeit slowly. As had been anticipated, in the consultation processes they were able to reach consensus faster on less contentious issues. Psychologically, by having some consensus, the two parties could see progress from their efforts and would feel that they were on the right track.<sup>32</sup> Consequently, the momentum for peace was maintained. In theory, the Mixed Committee was to seal the agreements that had been reached by the support committees and to negotiate on points of no-consensus. If the Mixed Committee still had difficulty in reaching

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<sup>32</sup>Personal account of Dr. Wirajuda who continuously chaired the Mixed Committee. He also stated the psychological satisfaction was an important aspect in conflict resolution and he suggested that he could relate his experience in chairing the meetings with the subject of conflict resolution as well as alternative dispute resolutions (ADR) he studied during his doctoral. Interview, 3 November 2001.



a consensus, the issues would be left for the leaders at the Formal Talks.

Meanwhile, at the domestic front of the Philippines, President Fidel Ramos embarked on extensive public diplomacy's campaign to inform the stakeholders and the general public about the diplomatic process so that they would support them. The sensitivity of the issue made public diplomacy essential, so that the various stakeholders would reach common understanding.<sup>33</sup>

Finally, on 30 August 1996, the parties to the conflict initialed the final peace agreement in the Presidential Palace (Merdeka Palace) before President Soeharto and by witnessing the ceremony, President Soeharto gave his personal support and 'blessing' to the agreement.

## CONCLUSION

The peace process to resolve conflicts in Cambodia and the southern-part of the Philippines was made possible by the existence of the 'ingredients for peace'. Those ingredients were the dynamics of relationships involving the parties to the conflicts and their stakeholders. For instance, the Ramos Government approached Indonesia for assistance because he was looking for alternative options

other than war to resolve the separatism issue of the Moro.

Nevertheless, at times further stimuli from international community are required in order to move the peace process forward. In Cambodia the assertiveness of the P-5 and new impetus for dialogue suggested by some countries, including Australia, had renewed the protagonists' interests for peaceful negotiation of their conflict.

The third party had played an essential part during the overall peace process. As a third party, Indonesia was able to initiate, facilitate and lead the peace process as well as to influence the dynamics of the protagonists' relationships. As a third party, Indonesian was able to play a constructive role because its internal dynamics were supportive for such a role. The Ministry's bureaucracy was determined in assuming their roles as facilitators for the peace process because they wished to achieve tangible results. At the same time, the Chief Diplomat, President Soeharto, gave his full blessing to the initiatives because he hoped that any success would enhance his stature at the domestic and international levels.

Indonesia's experiences in facilitating the peace process at the regional level should have given Indonesia with some lessons and best practices on how to deal with its internal issues of armed conflicts and separatism peacefully. By the time this

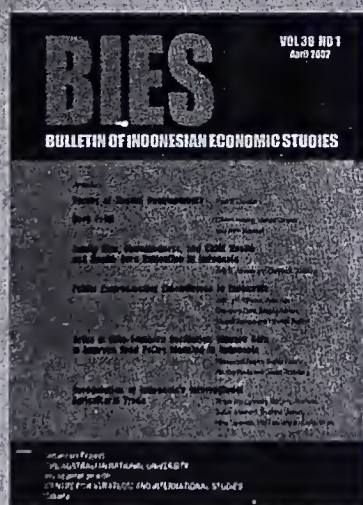
<sup>33</sup>See Teuku Faizasyah, "Indonesia versus GAM: a diplomatic puzzle," *The Jakarta Post*, 13 May 2003.



paper is being written, Indonesia has to deal with armed bands of separatist groups in Aceh and West Papua. In the case of Aceh, seemingly the Indonesian Government has given little hope for peace negotiation and has embarked on integrated operations, including the use of military operation to quell the Free Aceh Movement (GAM).

Despite this reality, both the protagonists (the Indonesian Government and GAM or other faction within the Movement) should not abandon any opportunity for peaceful solution to the conflict, even if the 'ingredients for peace' seems not very promising.

What they can learn from Indonesia's experiences as peace facilitator is that a discreet or informal contact would be the most appropriate initial steps to 'test the water' before resuming the peace dialogue. The third party—either Indonesians or non-Indonesians who have altruistic interests for peace or for regional stability—could help facilitate the contacts and the dialogues. However, Indonesia's experiences in dealing with Cambodia and Moro conflicts showed that the key for a successful dialog is to have shared views between the negotiators and equally important is to have the supports of the stakeholders.



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Payment should be sent to Rupiah Account No. 0018.01.000211.30.1, BRI Cabang Tanah Abang, Jakarta 10160.



# Greater Relevance of An Industrial Economics Approach in Emerging Rather than Developed Markets

*Heike Proff*

## INTRODUCTION

ONE of the fundamental challenges in strategic management is the uncertainty regarding the emergence of relevant conditions. This is a problem that is prevalent especially in emerging markets where the extent of uncertainty is often difficult to restrict since information in these markets is neither very reliable nor easily accessible. Moreover, fluctuations in the prevailing economic conditions render it difficult to make any prognoses (Elenkov 1997, 289). Thus strategic management seems to create certain peculiarities in emerging markets as compared to developed markets. This is borne out by a statement of the CEO of the internationally operating Mexican cement company, CEMEX: "Based on our experience with the turbulence of the Mexican and Latin American markets, the company is uniquely positioned to understand, manage and offer a competitive advantage into the rapidly changing

markets of Asia" (Zambrano 2002, 70). According to the low growth scenario projected by the OECD (1997), member countries of regional blocs such as AFTA, MERCOSUR and SADC in South-East Asia, South America and in southern Africa will increase their share of world GDP from 6.1% in 1995 to 8.2% in 2020. China alone accounts for 50%, 30% and 25% of the global production of cameras, air-conditioners and washing machines respectively (Legget & Wonnacott 2002, 30).

Principally, the theory of strategic management has been aimed mainly at developed markets till now. Increasingly, unique resources and competencies —obtained through the acquisition of additional input resources, for example— are being seen as underlying the strategies for approaching such markets. This is the reason why the "Boundary School" (Powell 1987 or Jarillo 1988) and the "Dynamic Capability School" (Prahalad & Hamel 1990; Barney 1991; Amit & Shoemaker

1993; or Teece et.al. 1997 are now regarded as the synthesizing approaches of strategic theory (Elfring & Volberda 2001). Both approaches are attributable to a further development of the resource-based approach within the scope of the competence perspective (Sanchez et.al 1996; Heene & Sanchez 1997; Sanchez 2001).

These recent developments in strategic management, however, should not result in earlier industrial organization-based or market-based approaches being ignored, since market-based and resource-based corporate advantages partly complement one another and need to be linked to consistent corporate strategies even in developed markets (Proff 2002). Clearly though, the relative significance of industrial economic approaches in developed markets is generally lower in comparison to the resource-based or competence-based approaches.

This paper attempts to show that the opposite is exactly true for emerging markets where industrialization is used as a means to achieve economic development. Industrial organization approaches would therefore be directly applicable here. The first section of this paper briefly outlines the strategic management approach to lasting competitive advantages. This is followed by an explanation on the significance of industrialization as a component of the development process which implies that an industrial economics approach possesses greater relevance

for tapping emerging markets. The paper concludes with a look at future developments.

## STRATEGIC MANAGEMENT AND LASTING COMPETITIVE ADVANTAGES

Both the market-based and resource-based views in strategic management, although differing, derive from market theory in the extended sense and from the industrial organization approach (see Rumelt et.al. 1991 or Foss et.al 1995, 2). Both research streams regard above average returns of firms as economic rents, i.e., as the surplus profit earned by producers who judiciously employ the factors of production [AM1].

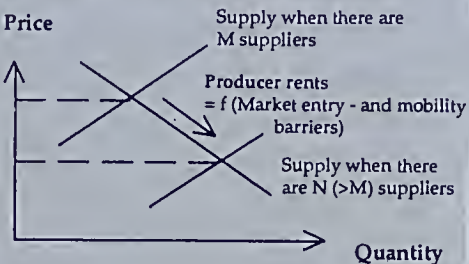
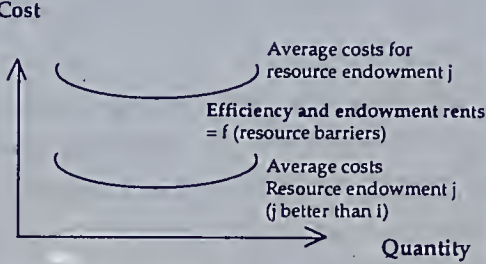
Both research streams, however, state different rationales for lasting competitive advantages (see Fig. 1). The reasoning is based on the competitive advantages of a business unit in a market.

The market-based view establishes oligopolistic or monopolistic rents in an existing market by reducing the number of suppliers or by affording protection from new competitors through agreements or market entry and mobility barriers (market-based competitive advantages, Fig. 1a). For this, it reverts to the traditional industrial organization theory or the market structure theory of the Harvard School and to the new industrial organization theory (based on game theory).



Figure 1

### DIFFERENT RATIONALES FOR LASTING COMPETITIVE ADVANTAGES IN THE MARKET-BASED AND RESOURCE-BASED VIEWS

	1a. Market-based view:	1b. Resource-based view:
Existing market	<p>The market structure determines producer rents (in extreme cases: monopolistic rents)</p>  <p>Competitive advantages resulting from</p> <ul style="list-style-type: none"> <li>Imperfections in the sales markets</li> <li>Reaction function and price/turn function</li> <li>Competitive adv. in home markets               <ol style="list-style-type: none"> <li>1. Advantages of economies of scale</li> <li>2. Capacity reserves</li> <li>3. Advertising</li> <li>4. Company image</li> <li>5. Probability of retaliation</li> <li>6. Reputation for retaliation</li> </ol> </li> <li>Competitive advantages through internationalization               <ol style="list-style-type: none"> <li>7. Reduction of surplus capacities through internationalization</li> </ol> </li> </ul>	<p>(1) * Better resource endowment or more productive resource utilisation lowers average costs.</p> <p>* Utilisation of organizational routines further lowers average costs.</p> <p>(Efficiency or endowment rents = Ricardian rents)</p>  <p>Competitive advantages resulting from resource heterogeneity</p> <p>Cost function</p> <p>Competitive advantages in home markets</p> <ol style="list-style-type: none"> <li>1. Advantageous access to raw materials and capital</li> <li>2. Advantageous location</li> <li>3. Access to govt. subsidies and contracts</li> </ol> <p>Competitive adv. through internationalization</p> <ol style="list-style-type: none"> <li>4. Leveraging comparative cost advantages</li> <li>5. Leveraging international tax differentials</li> </ol>
New market		<p>(2) Resource endowment as an adaptable knowledge base</p> <p>Process learning leads to monopolistic rents through monopolies over time</p> <p>Competitive advantages arise through innovative products and services</p> <p>Innovative capacity</p> <p>Competitive advantages in home markets</p> <ol style="list-style-type: none"> <li>1. Knowledge of learning processes and capacity to effect radical changes in the corporate structure e.g. through               <ol style="list-style-type: none"> <li>(a) very quick reactions to changes in the environment</li> <li>(b) very high external absorption capacity</li> </ol> </li> </ol> <p>Competitive adv. through internationalization</p> <ol style="list-style-type: none"> <li>2. Acquisition of additional input resources in a dynamic environment</li> </ol>

On the other hand, the resource-based view proceeding from market theory in its restricted sense (Chicago School), initially explains efficiency rents or endowment rents by means of better resource endowment or more efficient use of resources leading to declining average costs (parallel shift in Fig. 1b(1)). The concretization of economic rents through a more productive use of resources relates to the dissemination of individual knowledge. Certain organizational routines are required for this. They are prerequisites for optimizing management processes and for resource barriers or resource advantages through which average costs can be further reduced (additional efficiency rents through parallel shifts in Fig. 1b(1)).

In an existing market, the different rationales behind lasting competitive advantages as put forward in both approaches on strategic management can be illustrated using the three conduct functions of a firm. They provide the management with various options to act (Bain 1956; Simon 1992, 1999):

1. The reaction function, which demonstrates scope for action with respect to competitors;
2. the price/return function which creates scope for action in the market; and,
3. the cost function which enables intra-organizational action.

The *market-based view* accords management with scope for action only

in the market and against competitors in terms of the *reaction function* and *price/return function* (Fig. 1a). In this context, Dixit (1979) demonstrates in detail how competitive advantages can be derived from the traditional oligopolistic models in industrial economics such as: (1) advantages of economies of scale; (2) capacity reserves; (3) advertising; and, (4) company image. In addition, Karakaya & Stahl (1991) or Stead et.al. (1996, 61) explain competitive advantages using game theory, i.e., new industrial organization theory: (5) probability of retaliation and (6) reputation to retaliate. Furthermore, if there is internationalization of the company's operations, (7) reduction of surplus capacities can also be substantiated by traditional industrial organization theory.

The *resource-based view*, on the other hand, infers perfect competition (price=take) and no market entry barriers and therefore primarily regards the *cost function* as the parameter for action (Fig. 1b(1)). According to Peteraf (1993) et.al, the following factors, amongst others, are regarded as natural and institutional resource advantages: (1) advantageous access to raw materials and capital; (2) advantageous location; and, (3) access to government subsidies and contracts. Further advantages would accrue for international operations, such as (4) leveraging comparative cost advantages resulting from internationaliza-



tion or (5) leveraging international tax differentials.

Contiguous to this conduct function, the resource-based view offers explanations for market entry specific to a firm. By discarding rigid optimization calculations in a stable environment in favor of flexible calculations in an evolving and primarily dynamic or radically changing environment, it goes beyond the comparative static market-based approach. In a dynamic environment the existing market becomes a new market. Flexible calculations make it possible to ensure lasting competitive advantages in this case. Therefore, the resource-based view focuses on resource endowment as an adaptable knowledge base (Sanchez 2002). Time-delimited monopolistic rents are explained by the capacity to effect radical changes in the corporate structure based on a knowledge of learning processes (process learning, see Argyris, Schön 1978, 18) for a new market (Fig. 1b(2)). Competitive advantages would then arise only due to innovative products and services, i.e. not as a consequence of the three conduct functions but on the strength of *innovative capacities*. This allows us to derive the following advantages: (1) Knowledge of the learning processes and capacities for effecting radical changes in the corporate structure, e.g., through (a) very quick reactions to changes in the environment and (b) a very high external absorption capacity; and (2) Acquisition of additional input resources in a

dynamic environment which can occur if a firm decides to internationalize its activities.

The question arising at this point is whether there is any difference in the significance of these advantages in developed and emerging markets.

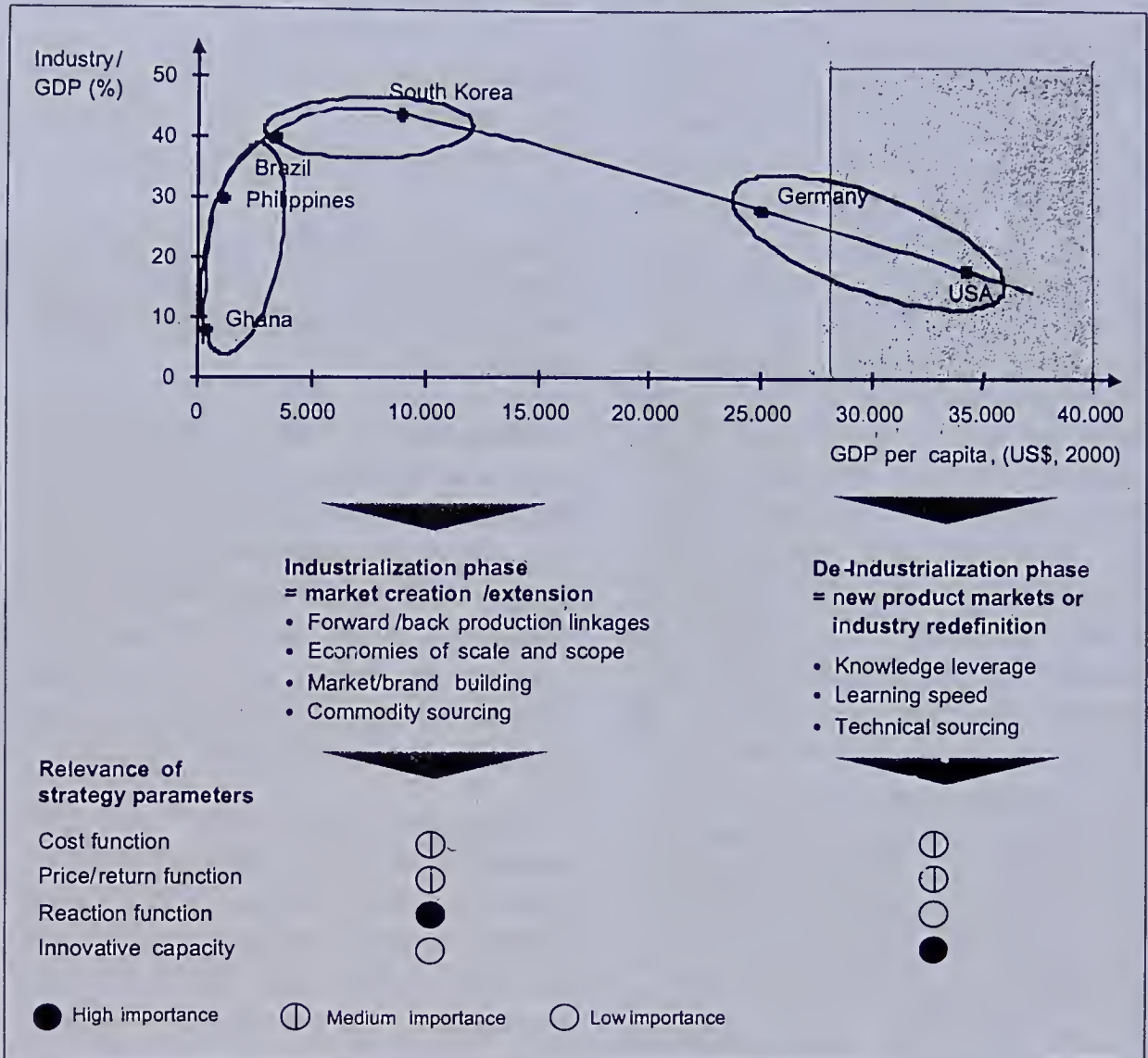
## GREATER RELEVANCE OF AN INDUSTRIAL ECONOMICS APPROACH IN EMERGING MARKETS

Whereas developed markets as a rule are already in a phase of de-industrialization in which the relative importance of the industrial sector for overall GDP is on the decline as opposed to the service sector, emerging markets are still in a phase of industrialization. The focus is thus on creating and expanding existing markets.

Industrialization, being a component of development in these markets, promotes the transition from a subsistence or barter economy to a market-based economy while simultaneously rationalizing all production processes. Figure 2 illustrates the ideal development process in highly developed national economies in relation to the share of the secondary sector in GDP (degree of industrialization) (The World Bank 2002). The figure shows that an increase in per capita income, and consequently in economic development usually takes place as a result of an increase in the degree of industrialization. A comparison between

Figure 2

INDUSTRIALIZATION AS A MEANS OF ECONOMIC DEVELOPMENT



Ghana, the Philippines, Brazil, South Korea and USA, for example, substantiates this development hypothesis. The Fourastié hypothesis of increasing tertiarisation of the economic structure states that the degree of industrialization displays a reverse trend after a GDP share of about 45%, as evidenced by the latest World Bank data and as has already happened, e.g., in the US.

In this phase of development, new product markets or industry redefinition are the key factors (Teece et.al. 1997; Sampler 1998).

A successful development strategy therefore requires the creation of an industrial structure with production processes that are knowledge, technology and capital intensive instead



of being merely labor intensive (Poapongsakorn & Fuller 1998; Grundlach, Nunnenkamp 1996). The objective must be the building up of competitive "pôles de croissance" (growth poles) or the creation of industrial clusters as put forth by Perroux or Hirschman (Wagner & Kaiser 1995, 41), that can spur growth in neighbouring regions or upstream or downstream industrial sectors through positive trickle-down effects. Such industrial clusters forming the core of an industrialization strategy can, over a period of time, develop into a diversified industrial network of backward and forward linkages between users and suppliers.

In this phase of market creation and market extension, it is economies of scale and scope, brand building and commodity sourcing that play a vital role (Titterton 2002). Due to the positioning process necessary in the market, the *reaction function* acquires particular significance. *Innovative capacity*, on the other hand, hardly plays a role here.

Only once the maximum degree of industrialization has been crossed and the transition to de-industrialization has been made do innovative capacities start to assume greater significance for emerging markets. This is the reason why countries such as Korea have been striving hard over the last years to attract and generate high technology industry (McKinsey & Company 2001; Larkin 2002). During the phase of de-industrialization, the

creation and expansion of existing markets take a backseat in comparison to the creation of new product markets (as put forward in the resource-based view) and changes in value structures. Leveraging knowledge, accelerating organizational learning, and ensuring a procurement network of technology-intensive intermediate products are much more in demand at this point than the advantages gained from economies of scale and brand building. Innovative capacity acquires special significance in this context (Sanchez et.al. 1996).

Apart from this, Figure 2 also illustrates that there is no difference between the two phases with regard to cost functions and price/return functions as they offer the firm scope for action in both phases.

The bias in the theory of strategic management towards building up firm-specific competencies, for instance, does not allow it to address issues specific to emerging markets. Strictly speaking, the theory is also only partially relevant in highly developed countries such as Germany or Japan. Given the increasing importance of emerging markets for multinational firms, Teece et.al. (1997) are correct in pointing out that the diversity of approaches in the theory of strategic management should not result in a meaningless lumping together of divergent lines of argument; rather, it should always be necessary to know which approach is optimal at a given point.



## FUTURE OUTLOOK

Market strategies for emerging markets should concentrate on understanding competitor conduct in the proposed economic sector. *Industrial economics* research plays a pivotal role in these countries where industrialization is still a key component of development. Theories on corporate governance or capital markets fail to address the core problems faced by firms that are either already engaged in or wish to be engaged in emerging markets.

A successful approach to markets in developing countries involves carrying out an in-depth analysis of the fundamental conditions governing economic activities in order to allow optimal use of the opportunities offered. Moreover, efficient markets must be created and expanded with the help of competitive advantages based on an industrial economics approach. Glittering metropolises should not make one blind to the fact that emerging markets, with few exceptions, are essentially "commodity-based economies" and cannot yet be regarded as sophisticated. A more discriminating approach, therefore, needs to be adopted when applying these theories to emerging markets.

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## **CONTRIBUTORS**

ARI A. PERDANA. Staff, Department of Economics, CSIS, Jakarta.

C.P.F. LUHULIMA. Senior Fellow, CSIS, Jakarta. Research Professor, Indonesian Institute of Science, Jakarta.

HADI SOESASTRO. Executive Director, CSIS, Jakarta.

HEIKE PROFF. Associate Professor of International Management, University of Mannheim, Germany.

MOHAMED ASLAM. Lecturer, Faculty of Economics and Administration, University of Malaya.

TEUKU FAIZASYAH. Phd Candidate, Waikato University, New Zealand.

S. WIRYONO. Negotiator for Aceh and former Indonesian Ambassador to Australia.